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BOOK REVIEWS

New York State Income and Franchise Taxes (Second Edition)

By Benjamin Harrow. PRENTICE-HALL, INC., New York, N. Y., 1951. Pages: xviii + 778; $10.00.

There is an unfortunate tendency on the part of most New York practitioners to neglect their study of state tax law. Because the New York State franchise, unincorporated business and personal income tax rates are relatively low, and these taxes are deductible on the federal return, the average practitioner has concentrated his attention on the more costly federal taxes.

The conscientious accountant, faced with this dilemma, and recognizing the possible disservice he may be rendering his clients insofar as state taxes are concerned, should welcome the publication by Prentice-Hall of Benjamin Harrow's "New York State Income and Franchise Taxes."

Actually this is a revision of an earlier book on the same subject written by Mr. Harrow and Mr. Isidore Sack, and published in 1941. It has been completely revised, brought up to date and is, at present, probably the most complete single-volume treatise on the subject.

Its set-up makes for effective use as a reference book by the busy accountant. Not only is it equipped with a complete topical index, but each chapter is preceded by a detailed sectional analysis of its contents.

This reviewer found Chapter 11 dealing with "Allocation and Segregation" for a business corporation particularly rewarding. There is ample opportunity for tax savings to be derived from an intimate knowledge of this section of the law. Mr. Harrow's exposition of the bases and techniques of allocation is extremely lucid and informative.

Chapter 6 discusses those instances where a corporation's net income, as reflected on its federal return, does not necessarily coincide with the true net income which is the basis for the franchise tax calculation. Chapter 20 sets forth the significant differences between the state and federal laws in the realm of personal income taxes. Knowledge of these variations is basic and invaluable. Virtually every accountant uses the federal return as the starting point in the preparation of its state counterpart. A thorough grounding in their points of departure will facilitate the preparation and review of the latter returns. There can be no doubt that these chapters can become effective tools in the hands of the busy practitioner.

For those who have not worked with the state taxing authorities and are not familiar with their procedures, the following chapters are recommended:

Franchise Tax:

- Audits, Assessments, Penalties, Interest and Liens
- Enforcing the Collection of Taxes
- Appeals

Personal Income Tax:

- Payment of Tax, Refunds and Penalties

There are innumerable other points of interest and value covered in this book. It is timely and fills a definite need. It is the reviewer's hope that Mr. Harrow will find the time to extend his studies to include the New York State Estate Tax.

JACK SCHLOSSER

New York, N. Y.

Specialized Accounting Systems, Second Edition

By H. Heaton Baily. JOHN WILEY & SONS, INC., New York, N. Y., 1951. Pages: xii + 579; $6.00.

From the title of the text the reader would expect to be presented with a highly technical exposition of the problems and procedures which confront the accounting expert attempting the design and installation of systems for businesses of an unusual nature. However, because of space limitation the author must content himself with generalized descriptions of thirteen types of specialized organizations. The book is therefore more in the nature of a general accounting text dealing with specific systems rather than a manual for the systems expert.

The general practitioner, the student and the candidate for the C.P.A. certificate will find the book informative and a desirable addition to his library. The systems expert will find it an ideal refresher. Professor Baily's coverage of the respective businesses and related accounting systems, though brief, is sufficiently instructive to provide the reader with a basic introduction to these specialized companies, not ordinarily acquired as clients nor treated in books dealing with general accounting principles and theory.

The section dealing with questions and problems on the subject matter of the text makes it adaptable for self-review and classroom use. This should be of particular interest to the candidate preparing for the C.P.A. examinations.

Although the author has presented the accounting systems of these thirteen uncommon businesses fairly well, he might consider reconstructing chapter fifteen entitled "System Construction and Installation." This new addition in the second edition leaves much to be desired, as it lacks the

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workmanlike qualities attributable to the rest of the book. Since this chapter has its place in the volume, it would appear more effective if redrafted and revised to include some system and internal control flow charts in addition to those used for the I.B.M. installations. It might also be renumbered chapter two and correlated, where applicable, with the succeeding chapters dealing with the specialized accounting systems reviewed.

Professor Baily has made a valuable contribution to the limited bibliography in the field of accounting systems.

SIGMUND ABELSON

New York, N. Y.

Basic Audit Case

By Harvey G. Meyer. PRENTICE-HALL, INC., New York, N. Y., 1951. Pages: i + 225; $3.75.

Designed to supply the need for a relatively short audit case that can be completed in one semester, this work attains its objective. It presents in one integrated problem the conditions and situations which the student would encounter in a small run-of-the-mill engagement and gives him an opportunity to dig out the necessary adjustments and corrections.

Emphasis is placed on the audit program and procedures without requiring a mass of detailed work on source materials. This enables the student to become conscious of the basic procedures and their importance in carrying the engagement to a successful conclusion.

The complete file of working papers for the previous year's audit is reproduced and should be helpful in assisting the student to prepare proper papers for his own work. In this connection it is interesting to note that while prepaid expenses were shown as a separate classification on the 1949 balance sheet, they have been included among current assets on the form for the 1950 comparative statement in accordance with the recommendation in Accounting Research Bulletin No. 30.

However, the author still uses the reserve terminology for the provisions for bad debts and depreciation despite the recommendation of the Committee on Terminology in Accounting Research Bulletin No. 34 that "the use of the term (reserve . . .) in the balance sheet, in describing deduction from assets . . . be discontinued."

Since a work of this nature is prepared for students, the reviewer believes it very important to conform with the recommendations of the Committees on accounting and auditing procedure of The American Institute of Accountants, as outlined in the Accounting Research Bulletins and Statements on Auditing Procedure, since those publications are the basis for many of the questions on the professional examinations.

FRANK A. DUNN

Iona College
New Rochelle, N. Y.

Credit Management Year Book (Volume 17)

Compiled by A. Leonidas Trotta. CREDIT MANAGEMENT DIVISION of the NATIONAL RETAIL DRY GOODS ASSOCIATION, New York, N. Y., 1950. Pages: x + 457; $6.00 members; $10.00 non-members.

The 17th volume of the Credit Management Year Book, like those published before, is a collection of articles by prominent credit managers and educators who discuss current problems which are of the utmost importance to the consumer credit grantor and all others interested in the subject.

The year 1951 looms ahead as one which will carry with it many problems—changes will come faster and have far more reaching effect than heretofore. We will be faced with new problems — higher prices — increased taxes—curtailed home building—credit controls—drafting of men into the armed forces —price and wage controls. These and others will tax our intelligence and know-how. The current issue of the Credit Management Year

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Book offers dependable help and guidance in answering some of the problems.

Consumer credit is now at an all time high and Management in its effort to meet increased costs of doing business is looking for additional volume. This, Management hopes to accomplish with a minimum of additional expense because every move counts as never before. The new Year Book brings to its reader 470 pages of practical, profitable know-how.

In this new volume a number of chapters on Credit Sales Promotion have been assembled and successful methods and approaches are discussed by recognized authorities in the field.

A complete chapter deals with the importance of the Accountant and his relationship to the Credit Manager in the small store. This was written by Mr. Kenneth C. Mages of Touche, Niven, Bailey & Smart. This chapter is a must for all accountants who do accounting work for retail stores which operate Credit Departments.

Collections and items of paramount importance in 1951 are discussed and, as an added treat, there is published the results of the collection problem clinic and the write-up on the happenings at the Collection Procedure Forum held at the recent annual Credit Managers Division Convention in Chicago. Invaluable information on this subject is contained in these two items.

Expense control and credit is always of great importance and this current issue publishes a study on bad debt losses and their report on the results of an expense time saver survey, which will be of great assistance to those who are looking for ways of doing things better and cheaper.

The current issue also covers a subject heretofore neglected—that of the consumer—and these top notch articles are written with a viewpoint of better customer relationship with the store and the Credit Department. The successful store of 1951 will have to consider this important item and many tips on pitfalls to look out for are discussed.

The Credit Bureau, without which the Credit Department could not function as successfully as it does, is discussed and after reading the article on this subject the only result to look forward to is better Bureau and Store relationship in our community which will surely result in smaller losses for each store.

Regulation "W" which is now once more in effect is outlined in full and the complete official text is presented.

Specifically, the new edition of the 1950 Year Book will help you solve today's and tomorrow's problems and provide a reference

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to assist you in your planning and in making your decisions. As in the past, Mr. Al Trotta of the N.R.D.G.A. deserves a round of applause for giving us a book on consumer credit which presents the facts so practically and can be of such immeasurable help in 1951.

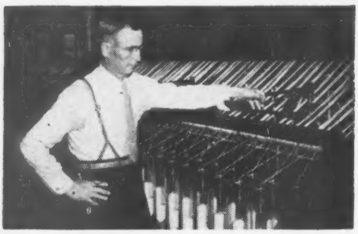
ALBERT S. KLECKNER

Credit Manager, Namm's
Brooklyn, N. Y.

"The bonds we bought for our country's defense bought and helped equip our farm!"

MR. AND MRS. CHARLEY L. WHATLEY OF CUTHBERT, GA. CAN TELL YOU—IT'S PRACTICAL AS WELL AS PATRIOTIC TO BUY BONDS FOR DEFENSE

Mr. Whatley inspects a beehive on his 202-acre Georgia farm. "My wife and I wouldn't own a farm, clear, today," he says, "if it weren't for U. S. Savings Bonds. They're the best way to save."



Charley Whatley says, "Mrs. Whatley and I joined the Payroll Savings Plan in 1943. Our pay averaged about $40 a week apiece and we put about a quarter of it into bonds. We had saved $6,925 by 1950."

"$4,000 in bonds bought us our farm and house, more bonds went for a new truck, refrigerator and electric range. We're still holding about $1,800 in bonds. Everybody should buy U. S. Savings Bonds!"

The Whatleys' story can be your story, too!

Your dream can come true, just as the Whatleys' did. *Start now!* It's easy! Just take these three simple steps:

1. Put saving *first* before you even draw your pay.

2. Decide to save a regular amount *systematically.* Even small sums saved this way become a large sum amazingly soon!

3. Start saving by signing up *today* in the Payroll Savings Plan where you work or the Bond-A-Month Plan where you bank.

You'll be providing security not only for yourself and your family, but for the free way of life that's so important to us all.

U. S. SAVINGS BONDS ARE DEFENSE BONDS— BUY THEM REGULARLY!

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THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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President's Message

THERE are many places in the world, Hawaii and Sicily for example, where people live happy and useful lives on prosperous farms or in little towns on the very slopes of volcanoes. The human quality that makes this possible is variously described as courage, indifference, fatalism or complacency. Whatever it is, it clearly is not an acute awareness of basic conditions nor is it an example of foresight or precaution.

If the close proximity of tremendous, elemental physical forces is not enough to overcome the all-too-human tendency to inertia and indifference, how much easier it is to give way to those debilitating tendencies when the damaging and disruptive forces are distant, abstract and almost unbearably complicated.

We know, in a way, that immense possibilities for damage and evil are all around us but we do not act on that knowledge. We try, too successfully, to put these unpleasant thoughts in the back of our minds and go on with our business and pleasures as usual. But the rumbles and reverberations persist and we will soon be forced into some sort of action.

The accounting profession has one of the heaviest responsibilities in this troubled time. Garbled and conflicting official statements and immense clots of gobbledy-gook thrown at the public and at business in the guise of governmental regulations and directives are evidences of our condition as are abortive control campaigns in which the leaders ride off madly in several directions at once and all the rest of the fuss and fury of a government sure that it must do something quick and drastic but still undecided on just what should be done.

The accountant should be, and can be, a most useful interpreter of government pronouncements. After a decade or so of exposure to revenue acts, regulations and treasury decisions almost anything seems simple and comprehensible and can be interpreted by the accountant. He is trained to analyze, to get down to fundamentals, to bring complicated conditions and transactions into an understandable form and compass.

We will have a new controlled materials plan with us on July 1 of this year and by May 1 we will have forms and regulations. The irreverent insist the initials "CMP" represent "confusion made permanent." They need not do so. The accountant should try to understand the forms and methods of this, and of other, control plans. He should explain them to his client and he should use all his professional skill and ingenuity to keep the paper work to a minimum.

The accountant who makes the effort to understand what is going on, who keeps up with current government and business developments, will be able to be of immense service to his client. He cannot get this knowledge quickly but must keep informed from day to day, preparing for the problems which almost certainly arise. The further we get into the defense program, or the further the defense program gets into us, the more valuable a clear-thinking, straight-talking adviser will be to the businessman. The accountant is eminently fitted to play such a role.

MAURICE E. PELOUBET

The Auditor's Report

Its Evolution in the U. S. A.

By GEORGE COCHRANE, C.P.A.

Introduction

DURING the past half-century, the economy of the United States of America has undergone a series of changes of import to the rest of the world.

In the year 1900, the population of the United States was approximately 76 million; to-day the population is estimated at something over 150 million—an increase of nearly 100 per cent. At the beginning of the century the number of individual enterprises in the U.S.A., including manufacturing concerns and farms, was approximately 6 million. To-day the number of such enterprises is estimated at 9.5 million.

GEORGE COCHRANE, C.P.A., is the immediate past President of our Society, and has been a member since 1931. He has been active in the Society as chairman or member of many committees, among them those on Budget and Finance, Furtherance of the Objects of the Society, Professional Conduct, and Meetings. At the present time he is a Director of the Society and chairman of its Committee on Awards.

Mr. Cochrane is a past Vice-President of the American Institute of Accountants, and is a Fellow of the Institute of Chartered Accountants in England and Wales. He is a partner in the firm of Deloitte, Plender, Griffiths & Co., New York.

This paper was the subject of an address delivered by him on September 12, 1950, at the summer course of the Institute of Chartered Accountants, held at Christ Church, Oxford, England. It was originally published in the November 4, 1950, issue of *The Accountant.*

As Sumner Slichter, one of our leading economists, has pointed out, this means that there are 9.5 million "clusters of private initiative" busily at work conducting enterprises which they hope will be profitable. In 1900 the national income for the United States of America was estimated at over $14,000 million. For the year 1949 it was more than $221,000 million.

Accounting as a profession in America has developed proportionately with the expansion of business enterprise, and it is recognized to-day as a fully professional form of activity. The concept of the auditor's independence, from which arises the respect for the objectivity of his opinion, has become an integral part of American business philosophy.

The economic role of the U.S.A. is crucial in the world of commerce and business to-day and the economic objectives of its business men have and will continue to have, for a long time to come, a substantial impact everywhere.

Some of the broad problems American business has faced and some of the alterations in business practices and principles which have occurred are clearly reflected in the evolution of American accounting.

In the following discussion I propose to trace the major changes which have taken place in the form of the auditor's report. In addition to the points of technical interest these changes reveal, they illustrate how business management has been called on to give the public a fuller account of its stewardship.

If those who to-day manage American business are more accountable to the public will than was the case a half-century ago, then the "accountability"

of the accountant is also greater. The evolution of the auditor's report is, perhaps, a special but certainly a revealing way of showing how and why some of these developments have come to pass.

Since Great Britain was the birthplace of the American accounting profession, the members of this audience may be particularly interested in knowing how members of the same profession, imbued with a common purpose but faced by different sets of circumstances, have managed to follow different paths to the same goal.

Background: Evolution of the Report

Reference will be made in the course of this paper to seven examples[1] of auditor's reports which have been used at different periods in the United States of America. The year given for each report indicates approximately the time when such report came into general use.

The forms of reports are those generally which have been used in connection with accounts submitted to stockholders by corporations engaged in industry and commerce.

Reports Nos. 4, 5, 6 and 7 have been used not only in connection with accounts submitted to stockholders but also in reporting on financial statements filed by companies with the Securities and Exchange Commission.

Basis of auditor's responsibilities

Since accountancy as a profession was introduced into the United States of America by British accountants during the second half of the nineteenth century, your auditing procedures were adopted by the early professional accountants in the United States. At the same time, the report which you used in those days was generally adopted, even though neither the American auditor's responsibility nor his duties had any statutory background.

The United States of America is a Union comprising forty-eight sovereign states, plus a number of territories and possessions. Each state has its own government and passes its own laws, the Federal government dealing only with matters specifically and constitutionally delegated to it. Under the Federal laws there is no provision for the formation of corporations. Thus a corporation must be organized under the laws of one of the states—and not necessarily the state in which it operates. While these laws, in general, are similar, they vary in a number of important particulars, but in one particular omission they are nearly all identical; except in one or two states, the corporation laws do not require accounts to be audited. Audit requirements generally arise from stock exchange listing agreements and regulations of the Securities and Exchange Commission.

In the absence of statutory provision, the responsibilities of professional accountants in examining accounts issued to stockholders depend for their definition on:

(1) Acceptance of responsibilities imposed through codes of ethics adopted by the professional societies.

(2) Pronouncements by the professional societies and the Securities and Exchange Commission of accepted principles of accounting and procedures and standards of auditing.

(3) Court decisions under the general statutes.

Until well after the end of the first world war there were practically no court decisions dealing with the duties and responsibilities of the auditor, other than British decisions, which latter largely influenced the American accountant's thinking and, consequently, his procedures.

[1] The examples are quoted at the appropriate places in the text of this paper and are reproduced together on page 334.

The absence of statutory provisions requiring the issuance of accounts to stockholders or the audit of accounts where they were required to be submitted, resulted in examinations which varied from a balance sheet audit to a full detailed examination, although the auditor's report might be couched in the same words. Usually the auditor was engaged by the directors or managing officers and the report was directed to them.

World War I

The period of world war I, an eventful one for the public accountant everywhere, was particularly eventful for those practicing in the United States of America. Roughly, that war marks the introduction of our first income-tax law (in 1916 the rate was 2 per cent., which to-day seems unbelievably low) and also the beginning of a great change in the investment habits of our citizens.

The rapid increase in the number of individual stockholders widened extensively the area in which corporate accounts carrying auditors' reports were circulated. As a result, there was a disproportionate increase in the number of those receiving such reports who were ignorant of their significance. Misunderstanding as to the object of the auditor's work was common, not only on the part of the average citizen but also on the part of bankers, credit grantors and business men.

It was widely believed, and to some extent still is, that the auditor's examination imbued the figures contained in financial statements with meticulous accuracy; that the auditor's opinion was a guarantee.

In an effort to correct these misunderstandings, a booklet known as "A memorandum on balance sheet audits" was prepared by the American Institute of Accountants at the request of the Federal Trade Commission, a government bureau, which approved the booklet and transmitted it to the Federal Reserve Board.

The Federal Reserve Board, after giving the document its provisional endorsement, published it in the Federal Reserve Bulletin of April, 1917. Reprints under the title "Uniform accounting: a tentative proposal submitted by the Federal Reserve Board" were distributed for the consideration of banks, bankers and banking associations; merchants, manufacturers and associations of manufacturers; and auditors, accountants and associations of accountants.

The bulletin was reissued in 1918 under the same sponsorship with a new title—"Approved methods for the preparation of balance sheet statements." There was practically no change from the 1917 issue except as indicated by the respective titles and a change in preface. The material contained in these bulletins was similar to that which is comprised in audit programs.

This generally was the background of the independent public accountant in the United States of America in his auditing practice at the end of world war I.

Origin of "certify"

Report No. 1, used from about 1900 until well after world war I, was worded as follows:

> *We have audited the books and accounts of the ABC company for the year ended December 31, 1915, and we certify that, in our opinion, the above balance sheet correctly sets forth its position as at the termination of that year, and that the accompanying profit and loss account is correct.*

The description of the auditor's examination as an audit of the books and accounts, and the use of the words "we certify", doubtless was due to the continuing influence of the English form of certificate.

In 1895 your Institute had handed to the Companies Acts Amendment Committee a memorandum which said, in part, "It is necessary that auditors should be especially guarded in their *certificate*", and in the judgment of the Court of Appeal in *London and Gen-*

eral Bank (*No.* 2) (1895) it was stated that "the auditor has to . . . *certify* that the balance sheet presented is correct . . ."

A profession, new in the United States, was growing up and the new accountant was willing to give his client what he wanted, i.e. a certificate, even in many cases capitalizing the words "WE HEREBY CERTIFY." To this day we have not entirely overcome the effect of this practice on the public mentality.

By the end of world war I the United States had changed from a debtor to a creditor nation. The huge accumulation of wealth, extensively represented by government war bonds, released by the government policy of national debt reduction in the early 1920's, introduced a period of reinvestment, speculation and inflation encouraged by methods of financial reporting which, in some cases, as the period ran its course, became fantastic.

Efforts were continually made by outstanding accountants to discourage these misleading accounting and reporting methods but, unfortunately, the professional accountant was not then clothed with authority either by statute or by public acceptance. Corporate management frequently depended on its legal advisers for accounting advice and the efforts of accountants to obtain acceptance of the accounting principles involved were nullified by advice that the presentation desired by the company was legal.

Under the statutes of many of the states, it was, and still is, legally possible to carry out transactions having accounting results not in accord with accepted accounting principles. Accounting principles were not then well defined and there was authoritative support for many practices which are banned to-day. The accountant now would look through the legal concept and insist on the applicable accepted accounting concept.

As the 1920's progressed, accountants more and more frequently objected to the practices used and many insisted upon qualifications in their reports. The qualifications were made by use of the words, "Subject to such and such, in our opinion", or "On the basis indicated, in our opinion."

It was not until many years later that the American Institute of Accountants recommended that an opinion should not be given where the qualification was sufficiently material to negative the expression of an opinion.

During the entire period 1900 to 1929 the opinion paragraph of auditors' reports included, as alternatives to "correctly sets forth", such phrases as "exhibit a true and correct view", "accurately record conditions", "represent the true financial position." The foregoing phrases implied a condition of exactitude which to-day is recognized as non-existent, in view of the conventions and philosophies which are the background of financial statements.

In the majority of instances only balance sheets were published during this earlier period and the auditor's work was generally confined to an examination known as a "balance sheet audit." The profit and loss account, referred to in Report No. 1 as correct, was usually one figure, shown on the balance sheet as the amount added to prior year's surplus, without any supporting statement.

The Situation in 1929

During the year 1929 the bulletin "Approved methods for the preparation of balance sheet statements", which had been in use over ten years, was revised by a committee of the American Institute of Accountants. The revised bulletin, entitled "Verification of financial statements", was issued by the Federal Reserve Board for the consideration of bankers, merchants, manufacturers, auditors and accountants. Issuance to accountants was necessary because the membership of the American Institute of Accountants in 1929 totalled only 2,185 and other accountants, who were not members,

numbered over 11,000. Even as late as 1929 the authority of the profession to speak on accounting matters had not reached a level where its pronouncements were accepted without the support of other authority.

The preface to this bulletin stated that

> "the scope of the work indicated in these instructions includes a verification of the assets and liabilities of a business enterprise at a given date; a verification of the profit and loss account for the period under review and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check. . . . The extent of the verification will be determined by the conditions in each concern."

While emphasis on the verification of the assets and liabilities was still retained, the verification of the profit and loss account was now added and was much more detailed than before.

The additional concepts recorded in the 1929 bulletin were:

(1) That the profit and loss (or income) account is of primary importance and, in consequence, that more audit work needs to be applied to profit and loss (or income) accounts.

(2) That the auditor properly places reliance on internal control (where it exists) and need not check in detail each transaction.

Instructions were given in the bulletin as to the scope of the examination and the manner in which it should be carried out, if a report and opinion were to be issued.

It was also recommended that the profit and loss account should be prepared in very much greater detail than formerly, so as to reveal the operating results for the period under review. Corresponding figures for one or more prior years also should be furnished, as being valuable information for the stockholder, prospective investor and the prospective credit grantor.

Report No. 2, still referred to as a certificate, was devised to meet the requirements of this bulletin and read as follows:

> *We have examined the accounts of the ABC company for the period from January 1 to December 31, 1929.*
>
> *We certify that the accompanying balance sheet and statement of profit and loss, in our opinion, set forth the financial condition of the company at December 31, 1929, and the results of operations for the period.*

It will be noted that this report did not refer to an examination of the books but only of the accounts, and the opinion covered not only the balance sheet but the statement of profit and loss, as setting forth the financial condition and the results of the operations for the period.

The *Ultramares* Case (1931)

As pointed out above, the corporation laws do not provide definitions of auditors' duties or responsibilities as such. Up to this time it had seemed to accountants self-evident that, if they were challenged, their liability would be measured by the principle of law that anyone who holds himself out to be skilled in any trade or profession and who is negligent in the performance of his work, becomes responsible for damages only to his client. In the case of an auditor, the client was the board of directors or the management that engaged him.

In the year 1931 there occurred an event which jarred the accountants' complacency and caused the adoption of Report No. 3 (see page 334).

A suit, dealing with their responsibilities and liabilities as auditors, was brought against a firm of professional accountants. This suit has become known as the *Ultramares* case. After being heard in the lower courts, the suit finally reached the Court of Appeals of the State of New York, the highest court in that state. The court held that an auditor's obligation under his contract is to his client only and to him he is responsible for negligence. Third parties not privy to the contract cannot hold the auditor for negligence. There must be a greater degree of

culpability than mere negligence, as liability of the auditor to third parties must lie in tort, and, therefore, gross negligence or fraud must be shown. The court said:

". . . although bankers, other credit grantors and investors may predicate their actions upon auditors' reports, it is obvious that no privity of contract can exist between the auditor and the public. The auditor's liability to third parties is based upon the law of torts.

"Negligence upon the part of an auditor",

said the court,

"creates no liability to third parties unless the negligence is so great as to be deemed equivalent to fraud. In that case there must be a false representation of a material fact known to be false by the party making it, or else recklessly made; the misrepresentation must be made with intent to deceive and for the purpose of inducing the other party to act upon it; the other party must, in fact, have relied upon it to his injury or damage."

The court continued:

". . . our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no belief in its adequacy, for this again is fraud. It does no more than say that if less than this is proved, if there has been neither reckless mis-statement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract and is to be enforced by the parties between whom the contract is made."

This decision was the most important rendered up to that time in the United States of America involving the duties and responsibilities of an accountant to his client.

Substantially, the question was whether or not the audit had been so grossly negligent as to constitute constructive fraud. If less than that were proved, the ensuing liability was one for negligence and could sustain a cause for action only by the party by whom the accountant had been engaged. The case was referred back to the trial court for rehearing but, unfortunately for the profession at large, was settled before retrial.

The Journal of Accountancy for July, 1931, made the following editorial comment:

"If we interpret this decision as the language seems to justify and if we may attempt to put it into an ordinary straightforward statement, it seems that the sum of the whole matter is this: Gross negligence may be regarded as evidence that fraud may have existed."

The Journal of Accountancy also asked the rhetorical question: "What is the accountant to do?" and supplied an answer indicating further changes which were later made in accountants' reports:

"Every accountant's report will be addressed to the client only . . . the accountant will divide his report into two sections, one dealing with fact (that is, scope of examination) and one with opinion. . . . The accountant perhaps should abandon certificates and merely make reports. . . . The word 'certify' which has been used for many years is quite inappropriate and should be abandoned. . . . It is absurd to speak of certifying an opinion."

Accountants, therefore, by again changing the wording of their reports, endeavored to make clear that the report was an opinion and not a guarantee. The word "certify" was eliminated and words indicating agreement with the books were removed. Report No. 3 read:

We have examined the accounts of the ABC company for the year ended December 31, 1931. In our opinion the accompanying balance sheet and statement of profit and loss set forth the financial condition of the company at December 31, 1931, and the results of its operations for the year ended that date.

Correspondence with the Stock Exchange (1932-34)

Need for improvement in financial reporting

The period of the 1920's ended with the stock market crash of October, 1929.

Demands arose from the public, professional and laymen alike, that methods be formulated which would avoid the repetition of the misleading financial reporting practices of the past years.

Recognizing the need for leadership, conferences were instituted between the special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange. The latter committee reviews applications from corporations for trading privileges on the exchange. The conferences commenced in September, 1932, and continued to January, 1934. They were conducted in an atmosphere of political change, economic confusion, financial disruption and suspicion, all of which brought about the far-reaching economic and social changes symbolized by the term "The New Deal."

On September 22, 1932, the Institute's committee, in a letter to the Committee on Stock List, stated that the nature of a balance sheet or an income account was quite generally misunderstood, even by writers on financial and accounting subjects. Consequently there were two major tasks to be accomplished:

(1) to educate the public in regard to the significance of accounts, their value and their unavoidable limitations; and

(2) to make the accounts published by corporations more informative and authoritative.

Alternatives for improving the existing situation were suggested. First, the selection by competent authority, out of the body of acceptable methods in vogue, of detailed sets of rules which would become binding on all corporations of a given class. This procedure had been applied broadly to railroads and other regulated utilities. The committee felt, however, that there were overwhelming arguments against any attempt to apply this procedure to industrial corporations.

The second alternative and, in the committee's opinion, the more practical one, was to leave every corporation free to choose its own method of accounting within very broad limits—but to require disclosure of the methods employed and consistency in their application from year to year.

Detailed suggestions by American Institute of Accountants to the New York Stock Exchange

The letter from the American Institute of Accountants listed a limited number of suggestions designed in part to carry out the general objective expressed above.

The committee advised the stock exchange that the principal objects which should be kept constantly in mind were:

(1) To bring about a better recognition by the investing public of the fact that the balance sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

(2) To emphasize the fact that balance sheets are necessarily to a large extent historical and conventional in character, and to encourage the adoption of revised forms of balance sheets which disclose more clearly on what basis assets of various kinds are stated (for example, cost, reproduction cost less depreciation, estimated going-concern value, cost or market whichever is lower, liquidation value).

(3) To emphasize the cardinal importance of the income account, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity; and to take the position that an annual income account is unsatisfactory unless it is so framed as to constitute the best reflection, reasonably obtainable, of the earning capacity of the business under the conditions existing during the year to which it relates.

(4) To make universal the acceptance, by listed corporations, of certain broad and generally accepted principles of accounting, and within the limits of such broad principles to make no attempt to restrict the right of corporations to select detailed methods of accounting which they consider best adapted to the requirements of their business, but:

(*a*) To ask each listed corporation to formulate a statement of the methods of accounting and reporting it employed in sufficient detail to be a guide to its accounting department;

to have the statement adopted by its board so as to be binding on its accounting officers; and to furnish the statement to the exchange and make it available to any stockholder on request and upon payment, if desired, of a reasonable fee.

(*b*) To secure assurances: (1) that the methods so formulated will be followed consistently from year to year; and (2) that if any change in the principles or any material change in the manner of application is made, the stockholders and the exchange shall be advised when the first accounts are presented in which effect is given to such change.

(*c*) To endeavor to bring about a change in the form of audit "certificate" so that the auditors would specifically report to the shareholders whether the accounts as presented were properly prepared in accordance with the methods of accounting regularly employed by the company, defined as already indicated.

Request to listed companies

In January, 1933, the President of the New York Stock Exchange addressed a letter to the presidents of all corporations listed on that exchange, as follows:

"The New York Stock Exchange has recently announced its intention of requiring audited listing applications after July 1, 1933. The public response to this announcement indicates clearly that independent audits are regarded by investors as a useful safeguard.

"If, however, such a safeguard is to be really valuable and not illusory, it is essential that audits should be adequate in scope and the responsibility assumed by the auditor should be defined. . . ."

The letter went on to say:

". . . in furtherance of this end we should be greatly obliged if you will secure from your auditors upon the completion of the audit for the year 1932 and furnish to the Committee on Stock List for its use and not for publication, a letter which will contain information on the following points:

1. Whether the scope of the audit conducted by them is as extensive as that contemplated in the Federal Reserve bulletin, "Verification of financial statements".
2. Whether all subsidiary companies controlled by your company have been audited by them. If not, it is desired that the letter should indicate the relative importance of subsidiaries not audited as measured by the amount of assets and earnings of such companies in comparison with the total consolidated assets and earnings, and should also indicate clearly on what evidence the auditors have relied in respect of such subsidiaries.
3. Whether all the information essential to an efficient audit has been furnished to them.
4. Whether in their opinion the form of the balance sheet and of the income, or profit and loss, account is such as fairly to present the financial position and the results of operation.
5. Whether the accounts are in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.
6. Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto."

This request made it necessary for the auditors of all listed companies to review their procedures. In those cases where the procedures had not been as full as were required by the bulletin "Verification of financial statements", arrangements were made for such work to be carried out in future.

A letter dated December 21, 1933, addressed by the American Institute of Accountants to the Committee on Stock List said, in part:

"While agreeing with your committee that in the case of large companies the safeguarding of transactions is primarily a matter of internal organization, we should like to make it clear that we fully appreciate the value of the detailed audit in appropriate cases. Where the internal check and control are necessarily limited or severely restricted, the detailed audit serves a most useful purpose, though no audit should be regarded as taking the place of sound measures of internal check and control, except in cases where the organization is so small as to make adequate internal check impracticable."

The letter then referred to the bulletin "Verification of financial statements", as revised by the American Institute of Accountants in 1929, the

first sentence in the general instructions of which read, in part:

> "The scope of the work indicated in these instructions includes . . . an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check."

In commenting on this excerpt from the bulletin, the Institute added:

> "We would, however, point out that it is always a matter of judgment on the part of corporate management to weigh the risks against which safeguards are desirable in comparison with the cost of providing safeguards. The whole matter lies in the field of discretion, and if in any case a defalcation should occur and escape detection, the accountants cannot be expected to accept any financial responsibility, but only to accept such blame as may attach to a possible error of judgment on their part with respect to their review of the methods and extent of the internal check and control."

The auditor's new report

Arising out of the correspondence above referred to, Report No. 4 was suggested:

> *We have made an examination of the balance sheet of the ABC company as at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.*
>
> *In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31, 1933, and the results of its operations for the year.*

This report was submitted by the Committee of the American Institute of Accountants with the following suggestions:

> "It is contemplated that before signing a report of the type suggested, the accountant should have at least made an examination of the character outlined in the bulletin, 'Verification of financial statements'.
>
> "The report should be addressed to the directors of the company or to the stockholders, if the appointment is made by them.
>
> "The statement of what has been examined would, of course, conform to the titles of the accounts or statements reported upon.
>
> "In the second sentence, any special forms of confirmation could be mentioned, e.g. 'including confirmation of cash and securities by inspection or certificates from depositaries'.
>
> "This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change, either in accounting principles or in the manner of their application, the nature of the change should be indicated.
>
> "It is contemplated that the form of report be modified when and as necessary to embody any qualifications, reservations or supplementary explanations."

While the requirements here outlined could only be enforced against companies listed on the Stock Exchange and their auditors, it immediately became evident that the accounts of unlisted companies and the examination thereof by accountants might well be considered inadequate unless the requirements had been met.

The Securities Act and other Legislation (1933-40)

Scope of the Acts

The conferences between the committee of the American Institute of Accountants and the New York Stock Exchange during the two-year period, 1932-34, were carried on against a background of severe public criticism of the financial community and corporate management throughout the United States.

The Congress of the United States passed a series of Acts, i.e., the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940.

While the scope of these Acts is nation-wide and they regulate many matters which previously had been con-

sidered the exclusive field of state legislation, the number of companies required to register under these Acts is but a small proportion of the companies doing business in the United States.

A commission composed of five commissioners appointed by the President of the United States of America was given authority to make, amend and rescind rules and regulations necessary to carry out the provisions of the Acts.

The commission was authorized to prescribe the form in which should be set forth the items or details in balance sheets or earnings statements to be submitted to the commission. It was also to prescribe the methods to be followed in the preparation of the accounts, in the appraisal or valuation of assets or liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income and of investment and operating income and other matters.

The Acts also reversed the rule that the burden of proof should be on the accuser and, where the Acts were operative, placed this burden on the accused. The only other Acts where this is so are the Income Tax Acts.

The accounting and auditing procedures required by the Securities and Exchange Commission and the penalties for failure to follow these procedures do not apply to balance sheets and accounts submitted by corporations to their stockholders or to the accounts of corporations not registered with the commission.

Nevertheless, if statements submitted to stockholders become the subject of litigation, it is believed the courts will take judicial notice of the accounting requirements of the Securities Acts and the type of disclosure required by these Acts. Consequently, great attention is now given to disclosure in corporations' accounts to stockholders, and such statements are little, if any, more condensed than similar statements supplied to the Securities and Exchange Commission. However, the detailed schedules required by the commission, as a rule, are not issued to stockholders.

Considerations of disclosure frequently cause the addition of notes to stockholders' accounts. Such notes may be added for the purpose of elaboration, but an item which is incorrect cannot be corrected by a note. When correction is needed it must be given effect in the statement.

When reviewing certain British company balance sheets at December, 1949, it was interesting to find that notes had been added and that these notes were referred to in your reports.

Auditors' liabilities under Securities Act

The civil liabilities affecting auditors under the Securities Act of 1933, as amended, are:

Section 11(a)

> "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein, or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may . . . sue . . . every accountant, . . . who has with his consent been named as having . . . certified any part of the registration statement, . . . with respect to the statement in such registration statement, . . . which purports to have been . . . certified by him."

The suit may be to recover damages representing the difference between the amount paid for the security and (1) its value at the time the suit was brought, or (2) the price at which the security had been disposed of in the market before the suit was brought, or (3) the price at which the security had been disposed of after the suit.

Liability may attach to an auditor under the Act for an error of judgment regarding the extent of the examination which he should have made, or through honest error or oversight on the part of an assistant normally competent and reliable. Obviously the cost, if an accountant is held liable, may amount to a very substantial sum.

The liability is somewhat complicated by the provision of the code, that reasonable belief by an expert as to truth and material fact must extend in point of time until the statements filed with the commission have become effective. This latter date almost invariably is later than the date of the auditor's report.

The standard of reasonableness when applied to the investigation to be made shall be that required of a prudent man in the management of his own property.

The Act, of course, placed a new and heavy responsibility on the professional accountant and, of necessity, increased his authority.

Consideration by the commission's staff, of the accounting principles used by the companies filing reports and of the audit procedures undertaken by the independent accountant in such cases, has led to a much wider knowledge of what is and is not, being done by corporations and accountants. Accounting principles and auditing procedures in specific cases are the subject of frequent conferences between the appropriate committees of the American Institute of Accountants and the commission's staff, in order to arrive at definitions satisfactory to both or an understanding of differences, when they exist.

Bulletin—"Examination of Financial Statements"—(1936)

The American Institute of Accountants, as the authoritative representative of a profession now well established in the business community, undertook the responsibility of revising earlier pamphlets and in 1936 issued a bulletin known as the "Examination of financial statements by independent public accountants." The preface stated that "developments of accounting practice during recent years have been in the direction of increased emphasis on accounting principles and consistency in their application and a fuller disclosure of the basis on which the accounts are stated." These developments had been accelerated by the prominence given to them in regulations of the Securities and Exchange Commission dealing with financial statements and also in the correspondence between the American Institute of Accountants and the New York Stock Exchange.

The bulletin pointed out that the suggestions were intended to apply to examinations by independent public accountants of financial statements prepared for credit purposes and for annual reports to stockholders.

A Major Fraud Case (1939)

Features of the case

American accountants had but commenced to practice in accordance with the 1936 bulletin when a serious fraud was disclosed in the accounts of *McKesson & Robbins, Incorporated,* which, for many years, had been audited by a prominent firm of independent accountants.

In the consolidated balance sheet of the company with a total of about $87 million of assets, approximately $19 million were found to be entirely fictitious — fictitious inventory items amounting to $10 million and fictitious accounts receivable amounting to $9 million. The case had a number of unique features: invoices, advices, shipping and other documents using fictitious names; recording fictitious transactions; forged contracts, guarantees and supposedly independent credit rating reports.

The president of the company had been living under a false name and was assisted in his malpractices by three brothers, also using false names, and occupying, respectively, the positions of assistant treasurer, manager of receiving, shipping and warehousing, and manager of offices, mailing, bank accounts and other activities. The president of the company had previously been convicted of commercial fraud, carried out in co-operation with his brothers. Before the investigation had proceeded far, the president committed suicide.

S.E.C. hearing

After a great deal of ill-informed discussion in the public press and investigation by both federal and state officers, a hearing was held before the Securities and Exchange Commission with three particular objectives. First, the ascertainment of the character, detail and scope of the audit procedure which had been carried out. Second, the extent to which prevailing and generally accepted standards of audit procedure had been adhered to and applied. Third, the adequacy of the safeguards inherent in the generally accepted audit procedure to assure reliability and accuracy of financial statements. Many expert witnesses were called and the whole matter was very thoroughly reviewed. There is no point, at this time, in reviewing all the matters taken up but, because of their relative size and the outcome, particular attention may be directed to inventories and accounts receivable.

The Securities and Exchange Commission, in regard to accounts receivable, found that, as a whole, the audit program conformed to then generally accepted procedures for an examination of financial statements, although confirmation of the accounts receivable by direct communication with the debtor was not included in the program. The facts of the case demonstrated the utility of circularization and the desirability of this procedure.

However, there seemed to exist a difference of opinion among accountants as to the extent of the auditor's duties and responsibility in physical verification of quantities, quality and condition of inventories. A substantial proportion of the profession took the position that investigation of quantities, quality and condition should be confined to the records. An equally authoritative opinion supported the view that auditors should make physical inspection of the inventory, either by test-counts, by observation of inventory-taking, or by a combination of these methods.

The outcome of this inquiry was to make the confirmation of receivables and contact with inventories by observation of inventory-taking mandatory audit procedures.

American Institute recommendations

The report of the Securities and Exchange Commission was not released until 1940 and by that time the American Institute of Accountants had adopted modifications of the bulletin "Examination of financial statements" issued in 1936. The modifications were published in a pamphlet called "Extensions of auditing procedure", which became the first of a series of twenty-four statements on auditing procedure subsequently issued by the Institute.

Recognizing the obvious requirements of the evidence before the commission, there was introduced into a new Report, No. 5, the statement that a review of the system of internal control had been carried out and that the examination had been made "by methods and to the extent deemed appropriate." The report, recommended by the American Institute of Accountants, read:

> *We have examined the balance sheet of the ABC company as of December 31, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.*
>
> *In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the ABC company at December 31, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.*

The use of this report (in the light of "Extensions of auditing procedure") required the auditor to satisfy himself, by suitable observation and inquiry, as to the effectiveness of the methods of inventory taking and the measure of reliance which could be placed on the

inventory records and the clients' representations as to quantity and condition. The American Institute's recommendation, however, laid special emphasis on the fact that the auditor did not hold himself out as a general appraiser, valuer or expert in materials. Implicit in the new report also was the representation that accounts receivable had been confirmed by direct correspondence where appropriate.

The findings and conclusions of the Securities and Exchange Commission upon the conclusion of the inquiry into the *McKesson and Robbins* case eventually were made effective for the purposes of the commission by amending their rules. In issuing this amendment, the commission stated that the auditor's Report No. 5 recommended by the American Institute of Accountants was defective for the purposes of the commission, in that the report did not state whether the examination had been made in accordance with generally accepted auditing standards applicable in the circumstances and did not state whether any procedures deemed necessary by the auditor had been omitted.

In order to meet the commission's view, Report No. 5, recommended by the American Institute of Accountants, was amended by the addition of the following words to the first paragraph:

> *Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures we considered necessary.*

So Report No. 6 became the report in general use and read:

> *We have examined the balance sheet of the ABC company as of February 28, 1941, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards aplicable in the circumstances and it included all procedures which we considered necessary.*
>
> *In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the ABC company at February 28, 1941, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.*

The report to-day

Finally, in 1949, Report No. 7 was introduced, after nearly twenty years of practice under conditions which had grown out of the correspondence with the Stock Exchange and the creation of the Securities and Exchange Commission. This report read:

> *We have examined the balance sheet of ABC company as of December 31, 1949, and the related statements of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.*
>
> *In our opinion, the accompanying balance sheet and statements of income and surplus present fairly the financial position of ABC company at December 31, 1949, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.*

Auditing standards had now been established through the issuance of the American Institute of Accountants' "Tentative statement of auditing standards" and the auditor's report was required to state that the examination had been carried out in accordance with such standards.

As it was now widely known and accepted that an auditor relied, and was entitled to rely, on the internal control in existence and on testing and sampling, rather than detailed examination, reference to these facts in the report was no longer required.

About 1948, the 1936 bulletin "Examination of financial statements" was recognized as obsolete, in view of the numerous important developments since its publication, and was allowed

to go out of print. In June, 1950, the American Institute of Accountants published a new pamphlet, "Audits by certified public accountants", which summarizes all the auditing standards and procedures agreed upon up to that time.

The Auditor To-day

While the American accountants' work is by no means limited to auditing, the auditor's report has become a document of great importance when the validity of financial reports is being considered.

Appointment

The auditor is nearly always appointed by the directors, not unusually by a small audit committee composed of directors other than managing directors, with which committee the details and results of the audit are frequently discussed. In some few cases the stockholders are the client, the appointment being made at the general meeting.

There is no longer doubt as to the purpose of the auditor's appointment. He is engaged to examine the balance sheet and related statements, which are representations of management, in order that he may offer an opinion thereon, and the examination must be made in accordance with specified standards. The standards are determined by the authority of the general body of professional accountants through the American Institute of Accountants, by means of carefully considered pronouncements, after careful research. The examination of books, records and other sources of information is made to obtain the best evidence available in justification of the opinion and such evidence is recorded by the auditor in carefully compiled files of working papers.

The examination is the detail of the auditor's work, the giving of an opinion is the objective. The auditor must assume the responsibility for determining the minimum detailed work to be undertaken and this responsibility is not one which can be shared by the client.

Independence

Professional accountants in the United States who obtain the title C.P.A. are frequently described as independent certified public accountants. This description is intended to emphasize the fundamental requirement of independence.

As it has been suggested, not infrequently, that the manner in which auditors are appointed in America represents a weakness in regard to independence, it seems desirable to consider this question.

As is above stated, the auditor, in the majority of cases, is appointed by the board of directors. In some few cases the appointment is made by vote of the stockholders at the general meeting. The choice seems to lie between these two methods of appointment.

After careful consideration, the conclusion has been reached that there is much advantage in the appointment being made by the board of directors and practically no disadvantage. Directors know better than stockholders the character of the firms of accountants available for employment and are more likely to hear criticism of the accountant's work. The directors have a fuller understanding of the intricacies of the business and accounting than the average stockholder. In addition, directors have personal responsibility for the management of the company and its financial reports. A sub-committee of the board of directors can, and frequently does, meet with the auditors and discuss understandingly and in detail any matters the auditors or the board consider desirable.

As the general meetings are attended by a relatively small number of stockholders voting personally, and a proxy committee of directors usually voting by proxies solicited at the expense of the company, appointment by stockholders' vote is, in effect, appointment by the directors.

The general opinion in America is that independence is a "state of mind" not affected by the source of appoint-

ment. Stockholder appointment is no doubt an attractive theory but it is not believed it adds to the auditor's independence. Independence is objectivity of thinking and impartiality of decision and to suggest that independence is impaired or strengthened by the source of the appointment is to imply a congenital human weakness which, where it exists, will not be removed by altering the entity making the appointment.

The standard of independence, as set by the American Institute of Accountants in its rules of professional conduct, is as follows:

> "A member shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a financial interest. . . . A member shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest . . . unless in his report he discloses such interest."

The rule on independence laid down by the Securities and Exchange Commission is, in part, that:

> "An accountant will not be considered independent with respect to any person (corporation) in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer or employee."

The rule further states that:

> "The commission will give appropriate consideration to . . . evidence bearing on all relationships between the accountant and the registrant (the company) and will not confine itself to relationships existing in connection with the filing of reports with the commission."

Opinion

The opinion must avoid ambiguity; it must be without equivocation, and must report whether the statements have been compiled in accordance with accepted accounting principles consistently applied throughout the year and from year to year.

Should the auditor require to qualify his report, he must state what the qualification is and its effect. If the qualification is material in amount or effect, the auditor must not offer an opinion on the statements as a whole and must state why he does not.

The scope paragraph of the report, describing the work, may give additional information as to particular items which have been examined; however, because such explanations could be interpreted as an effort to evade responsibility, this paragraph generally is not varied.

American accountants understand that English company law requires the auditor to report that the balance sheet is in accordance with the books of the company. While it is recognized, in the United States of America, that the financial statements are compiled from the books, it is not considered necessary to say so as, owing to summarization and reclassification, it is seldom that such statements will agree with the books, item for item. Nor is it believed necessary to state in the report that information and explanations have been received as, were this not so, the opinion would not be given.

The report now used, No. 7, requires that the opinion shall be expressed that "the financial statements present fairly the financial position in accordance with generally accepted accounting principles applied on a consistent basis." Generally accepted accounting principles are rules and doctrines developed over a period of years, which authoritative bodies, the American Institute of Accountants in particular, have adopted as best calculated to present fairly the financial position and the results of operations.

The accounting research bulletins of the Accounting Procedure Committee of the American Institute of Accountants, while a guide on many controversial accounting subjects, are not considered to have indisputable authority

until they have gained general acceptance from use by corporations and the practice of the general body of practicing accounting firms.

Accounting principles are not static, being constantly under consideration and review in the light of changing conditions.

Even now, consideration is being given to all the bulletins which have been issued to the end that they shall be brought up to date and, if possible, codified. It is not intended that accepted principles shall be a set of fixed rules but a background, against which corporation officials and others shall exercise judgment in adopting a particular method to record in accounts any of the varied situations which arise from the operations of business.

Should it become desirable to change the methods of accounting previously adopted, the effect of the change must be disclosed and the auditor in his report may express his approval of the change. If he disapproves and the effect is material he will either qualify his opinion or not offer an opinion.

As accounting principles are not rigid and there exists a choice in their application, consistency is of major importance and the auditor is required to express his opinion with respect to consistent application.

Responsibility continues to be placed upon the accountant but now he also has authority. The day is long past when others than accountants determined acceptable solutions of accounting problems. By education, training and self-discipline the certified public accountant has set for himself a professional status fully equal to that of the older professions of medicine and law.

To justify this public acceptance, the members of the American Institute of Accountants and nearly all the state societies have adopted codes of ethics which are as severe as those of any other professional body. What is more important, the codes are strictly administered.

Corporations

From the beginning of the century until after the market crash of 1929 there had been little recognition by corporation management of its obligation to supply stockholders with any but the most meagre information, despite the fact that those who were known as the "insiders" invariably obtained any information they required. The need or even desirability of publishing information of interest to employees had not been considered. Financial reports were condensed, on the theory that if information had been made available it would have been used by competitors, unions and speculators to the disadvantage of the reporting corporation.

With the introduction, as a result of the correspondence between the American Institute of Accountants and the Stock Exchange and under Securities Act practice, of the requirement to disclose material fact and information required to make the data published not misleading, these reticences were swept away. Directors were no longer prepared to accept the responsibility of non-disclosure and, in any event, experience soon demonstrated that the detrimental results which had been feared never materialized.

Directors and management now recognized their responsibility to account not only to the proprietors of business but to employees and the public at large. To discharge this responsibility, accounts are fairly presented only if in accordance with accepted principles of accounting consistently maintained. Accounts are "fair" in that they are impartial, equitable; and "present" in that they exhibit to view, bring to notice, disclose material facts. In the past, conservatism has been widely praised as an accounting virtue, even to the extent of condoning departures from accuracy. While conservatism is still one of the attributes of accounting, understatement may be as objectionable as overstatement.

The balance sheet, statement of financial condition, or statement of

ownership as it is now frequently entitled, must adequately disclose the information it purports to convey. The profit and loss account is no longer the tightly condensed, uninformative statement of former years. Sales, cost of sales, details of expenses, taxes and unusual or non-recurring items are shown, so that the net income for the year is a meaningful figure. The results shown by the statements are comparable with similar figures of prior years because of the required consistent application of accounting principles.

In the United States of America there are a number of financial reporting agencies, and directors and management recognize that the public turns to these agencies for information and guidance. Corporate reports must, therefore, be reasonably susceptible to statistical processes.

Stockholders' reports are up to date, many corporations, the largest as well as those of moderate size, completing and publishing their annual accounts within sixty to ninety days of the year-end. Many financial and investing corporations issue accounts quarterly.

In financial reporting, American management is meeting the demand that not only results but information shall be supplied to the proprietors of the business and the public at large.

Public effect

The interest of government in the results of business naturally has heightened with the increasing need for greater revenue through taxation. The demands of unionized labor, direct or through social legislation, continually require more and more dependable figures, made acceptable by disinterested professional opinion thereon. Banks, finance and factoring companies and other credit grantors generally demand audited statements when considering applications for loans. These institutions—government, banks and labor union experts—however, constitute a sector of the public which is educated to a full understanding of the science and art of accounting. They can be depended upon to know the language of accounting, its conventions and the significance of the auditor's report. Unfortunately, there are millions of individual investors who are neither educated in the language of accounts nor informed as to its conventions. While no science or art can expect to express itself in unscientific or unartistic terms, every effort should be made, particularly in a field charged with public interest, as is accountancy, to avoid language known only to the initiated.

Is it possible that, in their present form, using the conventional terms, financial reports are not understandable by the masses, to whom facts must be told if the world-wide attacks on free enterprise are to be repelled and the attackers defeated?

A recent independent survey of public opinion in America brought to the attention of the professional accountant the need that exists for much wider education of those who should be informed by financial statements and the directors' and auditors' reports appended thereto.

The survey produced the following findings:

45 per cent. of the public believes that the reported profits of corporations are understated.

59 per cent. of the public believes that it is difficult to understand an income statement.

40 per cent. of the public does not understand many of the terms used in accounting.

These figures are perhaps no cause for great alarm, though we must surely consider them soberly. One might even say that the surprising thing is not so much the widespread lack of belief which corporate reports seem to have, but rather the fact that the area of disbelief is not even wider. For, after all, the practice of reporting fully and completely to investors and the general public in the U.S.A. is of comparatively recent origin, if we consider things on a long-range basis. It is quite clear that, as American business grows and

becomes more complex, business management will move further and further in the direction of still more comprehensive reports prepared always with a view toward satisfying the needs of third parties and the public generally. My own belief is that business will succeed in fostering greater confidence in its reporting methods—and that the accounting profession will be able to play an important role in this development.

Conclusion

In the light of the facts uncovered by an examination of accounting history in the United States, it seems to me that three conclusions are inescapable.

First, the accounting profession in the United States has gone through an evolution different in form from that followed by the profession in Great Britain. One interesting aspect of this is somewhat paradoxical: In Great Britain, which gave the world the common law, the development of the accounting profession doubtless received much impetus from the requirements of statutes making audits compulsory, whereas in the United States, where government rests to a greater extent upon statutes, auditing has developed because the business community has recognized the independent audit as commercially desirable. The accounting profession in the United States is dependent for its authority in auditing on a form of common law based on the decisions of the organized profession and the acceptance of such decisions by the public at large.

Second, the changes which have taken place in the field of auditing in the United States have been designated very largely by concrete economic circumstances, intermixed with important ethical considerations flowing out of changing ideas about management responsibilities to the public. This is as it should be. It would be unrealistic to assume that important changes could or should be brought about in a vacuum. Changes in accounting methods tend to be most sound when they reflect changing economic and business conditions.

Third, although the profession in the United States and the profession in Great Britain have evolved along slightly different patterns, the basic goals of each have remained similar. When we consider auditing as a group of techniques for measuring, checking and evaluating business progress, in a spirit of independence and objectivity, we find that the aims of the profession in both countries are, after all, substantially identical.

In my concluding remarks, I would like to suggest that the third point—the identity of our interests and aims—is of very broad and sweeping importance to the economy of the whole world. The reason that importance attaches to this fact seems to me clear. To-day, in a time when crisis seems to be constantly in the air, a great part of the task of providing world leadership, in terms of economic and political thinking, has fallen to the United States and to Great Britain. Moreover, the views of business men in these two countries exert a powerful influence on world economic thinking and on political activities designed to accomplish the best ends we can envisage. I do not believe many people would deny that in the foreseeable future Great Britain and the United States will continue to play major roles. This is true both with respect to broad and long-range activities, such as the building of political structures dedicated to peace, and with respect to more specific and immediate goals, such as the efforts being made on both sides of the Atlantic for the economic development of underdeveloped areas.

If this is so, then it is very good, indeed, that the members of the accounting profession, going beyond the specific differences caused by their national histories, are able to find a common basic unity in the philosophies and practices which provide the real mo-

tivation and driving force for their growth.

It has not been my intent to digress into fields of politics and economics; my original purpose has been to discuss the development of the auditor's report in the United States. None the less, as I conclude, I think it is reasonable and proper for us to take comfort and inspiration from the fact that we seem to live in an accounting age, an age in which accounting appears destined to have an ever-increasing part in fostering stability and progress.

FORMS OF AUDITORS' REPORTS

Referred to in this paper

No. 1

We have audited the books and accounts of the ABC company for the year ended December 31, 1915, and we certify that, in our opinion, the above balance sheet correctly sets forth its position as at the termination of that year, and that the accompanying profit and loss account is correct.

No. 2

We have examined the accounts of the ABC company for the period from January 1 to December 31, 1929.

We certify that the accompanying balance sheet and statement of profit and loss, in our opinion, set forth the financial condition of the company at December 31, 1929, and the results of operations for the period.

No. 3

We have examined the accounts of the ABC company for the year ended December 31, 1931. In our opinion the accompanying balance sheet and statement of profit and loss set forth the financial condition of the company at December 31, 1931, and the results of its operations for the year ended that date.

No. 4

We have made an examination of the balance sheet of the ABC company as at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31, 1933, and the results of its operations for the year.

No. 5

We have examined the balance sheet of the ABC company as of December 31, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the ABC company at December 31, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

No. 6

We have examined the balance sheet of the ABC company as of February 28, 1941, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it included all procedures which we considered necessary.

In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the ABC company at February 28, 1941, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

No. 7

We have examined the balance sheet of ABC company as of December 31, 1949, and the related statements of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet and statements of income and surplus present fairly the financial position of ABC company at December 31, 1949, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Budgetary Problems in the Light of the Current Emergency

By Eugene P. Hagan, C.P.A.

A budget consists of a series of estimates which, when taken as a whole, can be used as a program for operating an enterprise for a specific period in the future and to attempt to forecast the results thereof. Its use has become a definite part of management practice in most major concerns.

However, budgets need by no means be restricted to so-called "big business." They can, and should be, effectively used by small or medium-sized organizations. Every business, regardless of the size, must endeavor to meet product demand, and has as its prime purpose the earning of a fair profit. Budgeting is a means toward achieving these ends. Not that a budget will assure or increase profits; but it offers management a co-ordinated definition of its objectives, highlights the requirements to meet these objectives, and measures the extent to which the planned objectives are being attained.

The small business man has failed so far to appreciate fully the import of budgetary controls and, consequently, has failed to exploit their use. Formal methods of forecasting have been looked upon by him as unsuited to his limited needs; and, where he may be convinced of their merits, he argues that they are too costly to maintain. It is a fundamental duty of the accounting profession to apprise "little management" of the efficacy of financial planning, to dispel the misconception that budget procedures are complicated and costly, and to encourage their more wide-spread adoption.

Eugene P. Hagan, C.P.A., has been a member of our Society since 1941 and is presently serving on our Committee on Budgets and Budgetary Controls. He is also a member of The American Institute of Accountants and of the National Association of Cost Accountants. He was graduated from the School of Commerce, Accounts and Finance of New York University with the degree of Bachelor of Science, and is now associated with Touche, Niven, Bailey & Smart.

In a period of general business expansion, such as we are now undergoing, it becomes imperative that small manufacturers adopt budgeting. The government has been letting, and will continue to let for some time under our present defense and mobilization set-up, innumerable contracts. It is not unlikely that the small firm will benefit therefrom, and will, therefore, become faced with problems of growth. Does the acceptance and execution of the contract mean extension beyond current production needs and capacity? What will be the effect on personnel requirements? Will facilities have to be enlarged? Is such expansion advisable? When can it be accomplished? Can cash funds be furnished? During static periods of business, rules-of-thumb although somewhat haphazard have been adequate. However, coping with problems of increased activity necessitates a well-organized plan of attack based upon detailed accurate facts, so that an orderly systematic approach will be followed instead of incomplete or hastily prepared calculations that may mean exposure to unnecessary losses.

An indication of the growing role that the budget is assuming in the financial structure of the small manufacturer, is the importance banks and credit agencies have been placing upon the projection into the future of a pro-

spective borrower's position. These institutions, which supply the cash lifeline to smaller enterprises, are finding that the customary Balance Sheet and Profit and Loss Statement, while offering an acceptable picture of the financial position as at a certain date and a complete record of operation for a past period to that date, are insufficient where additional financing is being sought for expanded operations. Consequently, it is becoming common practice for these institutions to require a formal forecast of anticipated operations and financial position.

The preparation of a budget requires the compilation and classification of certain information and data. The accounting results of past performances must be analyzed. Detailed information with regard to the activities, internal procedures, and over-all policies of a business must be comprehensively accumulated. Statistical data as to general business conditions and market and trade trends have to be obtained and indexed. While it is true that the larger manufacturers are well-staffed with highly trained personnel for the collection of pertinent information, the independent public accountant serving small business is in a position to offer his clientele an invaluable service.

It is not expected that the independent public accountant take upon himself the entire burden of compiling the information, preparing the budget, and controlling its program. It is not uncommon for the individual practitioner, however, to be consulted and give advice on all phases of policies to be employed by his client. In this capacity, the independent accountant obtains a deep sensitivity for and comes to understand the small business man's wants and needs. He becomes well-qualified to install appropriate budgetary methods, guide the client in making intelligent estimates, and supervise and assist in fulfilling the terms of the budget and its objectives. His close knowledge of the firm's operations insures the installation of practical budgeting procedures with a minimum expenditure of his time and effort. His technical training and background will enable him to keep the requisite schedules as simple and effectively complete as possible.

The workings and preparations of a cash budget were more fully described in a previous article that appeared in the January, 1950, issue of *The New York Certified Public Accountant.** This article presents an outline of procedures that may be used by a manufacturer in establishing a complete operating budget. It is offered as a comprehensive outline of all the necessary steps to be followed in preparing a budget and indicates the nature of the required data. The outline has been made all-inclusive to fit an ideal situation; but specific sections can and may be used to fit individual circumstances, or may be made to comply with specific cases. In a series of articles to follow, individual case studies of various industries will be presented to illustrate the practical effects of budgeting.

A MANUFACTURING CORP. OPERATING BUDGET FOR THE YEAR 1951

The Sales Budget

Sales Estimates

Sales estimates should be as accurate as possible, because they are the basis of the entire budget. To a large extent the budgets of other departments merely result from computations based on the budgeted volume of sales. Such budgets will be accurate only to the extent that the sales estimates will be realized.

The data required for the sales forecast was obtained by the A Manufacturing Corp. from:

1) Analysis of past results
2) Market analysis
3) Product analysis

* A Simplified Financial Budget for Smaller Manufacturers, by Fred Rubman.

Analysis of past results:

Data as to past performance was assembled in such a way as to be of maximum value in estimating future sales. The analysis of past results was prepared for each type of product to show for each month of the year:

1) Orders received
2) Cancellations
3) Deliveries
4) Returns
5) Net deliveries

Market analysis:

The market analysis entailed collecting all the pertinent information available in regard to a given territory, and organizing and analyzing the data to determine the company's position in a given territory. By this means, the company attempted to learn about past and present demand for its product, how it stood in relation to competing businesses and competing types of products, and the probable future demand for its merchandise.

The required information was obtained from published trade reports and information gathered by salesmen from jobbers.

Product analysis:

The status of each type of product was studied with respect to marketability and profitability. The data gathered was analyzed to determine:

1) Extent of demand therefor
2) Cost of creating the demand
3) Whether after allocating distribution costs the item is being sold at a profit
4) Advisability of encouraging sales or discontinuing the product.

Making the Budget

After projected delivery schedule was prepared in terms of quantities, unit sales prices were applied to arrive at the amount of the monthly sales. Prospective changes in unit sales prices were, of course, considered. The monthly budgeted sales so determined as compared with actual sales for the previous year are as follows:

	Budgeted sales, year 1951		Actual sales, year 1950	
	Quantity	Amount	Quantity	Amount
January				
February				
March				
April				
May				
June				
July				
August				
September				
October				
November				
December				

The Production Budget

Objectives

The production budget is primarily concerned with the planning of production schedules to insure a stock of goods sufficient to fill sales orders. It is important to time production in such a manner as always to have sufficient inventories to meet sales requirements. At the same time it is important to manufacture the required quantity as economically as possible.

Achieving these primary objectives requires consideration of several interrelated factors, namely:

1) Length of production period
2) Desirability of an even flow of production

3) Control of inventories
4) Adequacy of plant facilities
5) Availability of raw materials
6) Availability of labor supply

Length of production period:

The length of time it takes to manufacture the finished product determines the flexibility of the production program. If a short period of time elapses between the starting of an order in the shop and the delivery of the finished product to the storeroom, mistakes in long-range planning of production are relatively unimportant because production can be increased to provide quickly for unexpected requirements. If, however, the production period is long, much more careful planning is required.

Desirability of an even flow of production:

Attaining an even flow of production is desirable for a number of reasons. It results in greater stabilization of employment which reduces labor turnover. The inefficiencies resulting from peak production loads are eliminated by an even flow of production. A further advantage is the reduction in plant capacity required to carry uneven loads.

Control of inventories:

In planning production, consideration must be given to having on hand sufficient quantities of goods to meet varying seasonal demands. A proper balance must be maintained between the objectives of (1) maintaining an even flow of production, (2) providing sufficient merchandise to meet delivery schedules promptly, and (3) avoiding the accumulation of excessive inventories.

Adequacy of plant facilities:

Plant facilities must be adequate to meet the necessity of peak loads. Plant expansion should be considered with an eye not only to present needs but to future possibilities. Management must consider the feasibility of arranging for the necessary additions, bearing in mind the time lag before the additions can be made available and the possibility of financing the necessary investment.

Availability of raw materials:

The plant manager should always know whether a sufficient supply of materials will be available at reasonable prices, as needed. Storage facilities must be adequate to house the required quantities.

Availability of labor supply:

Where skilled labor is required, the availability of such labor and the time required for training must be considered in connection with planned production.

The Annual Budget

The production budget for the year is determined as follows:

	Product A	Product B	Product C
Quantity required to fill sales orders (per sales budget)			
Planned inventory, December 31, 1951			
Less inventory, January 1, 1951			
Required production			

The Monthly Production Budget

After determining the required production for the year, the following monthly production schedule was budgeted:

	Product A		Product B		Product C	
	% of total production	Quantity	% of total production	Quantity	% of total production	Quantity
January						
February						
March						
etc.						
	100%		100%		100%	

The Material Budget

Method of Preparation

The materials budget is prepared to show, in quantities only, the direct materials which will be needed to manufacture the required production. The quantities of direct materials budgeted are determined by multiplying the number of units of finished goods required to be produced by the quantity of material per unit of finished product. This data is obtained from cost records or carefully prepared estimates.

Direct Material Components

In manufacturing its three products, the A Manufacturing Corp. uses five direct materials. The quantities of these materials used per unit of finished product are:

	Product		
Material	A	B	C
V			
W			
X			
Y			
Z			

The Materials Budget

On the basis of the monthly production budget and the direct material components, the following monthly materials budget was prepared:

	Units to be produced	Quantity of material for finished unit	Material				
Month			V	W	X	Y	Z
January							
February							
March							
etc.							

The Purchase Budget

Computation of Purchase Requirements

After the quantity of each direct material required for the production program has been determined, it then becomes necessary to estimate the quantity to be purchased. The budgeted requirements of material V for the year are determined as follows:

Quantity required for production	
Planned inventory, December 31, 1951	
Less inventory, January 1, 1951	
Purchase requirements	

In determining purchase requirements for any given month, consideration must be given to time required for delivery. It thus becomes necessary to establish the minimum quantities of materials which it is safe to carry at any given time in order to have an adequate supply and yet not be overstated.

Monthly Purchase Budget

The monthly cost of budgeted purchases for material V is determined as follows:

Mo.	Required for production	Production plus desired inventory		Beginning inventory	Purchases			Cost at estimated unit price
		Minimum	Maximum		Minimum	Maximum	Budgeted	
Jan.								
Feb.								
etc.								

Summary of Materials Purchase Budget

After the monthly budgeted cost of each of the direct materials was determined, the following summary was prepared:

	Budgeted cost of material					
	V	W	X	Y	Z	Total
January						
February						
etc.						

The Labor Budget

The labor budget indicates the expected cost of the direct labor which will be required for the manufacture of products in the quantities indicated by the production budget. The labor cost is computed by multiplying the number of units of finished goods to be produced by the labor cost per finished unit. The unit labor cost should be available from cost records and should be adjusted for expected revisions.

The Monthly Budget

The budget as computed for product "A" is as follows:

Month	Production budget	Unit labor cost	Labor cost
January			
February			
etc.			

A summary of the monthly labor budget by products follows:

Month	Labor cost for product			
	A	B	C	Total
January				
February				
etc.				

The Manufacturing Expense Budget

Estimating and Allocating Expenses

The expense budgets should usually be prepared by the person authorizing the expenditure. The estimates should be based upon the prior year's experience and anticipated requirements.

Fixed expense should usually be distributed evenly over the period. Variable expenses should be allocated in relation to production.

Before the budgets of the operating departments can be prepared, the budgeted expense of the service departments must be determined and distributed to the operating departments.

Manufacturing Expense Budget

The budget as determined is given below:

Expense	Actual 1950	Budgeted 1951					
		Total	January	February	March	April	Etc.
Indirect labor							
Indirect material							
Rent							
Power							
Light							
etc.							

The Selling and Administrative Expense Budget

Preparation of the Budget

The expenses of the prior year should be analyzed as the first step in the preparation of the selling and administrative expense budget. This analysis should not only reveal the fixed and variable expenses which form the basis of the budget estimates, but it should also indicate what items may be eliminated or reduced by better efficiency and what additional expenses are warranted by expected returns.

The Cash Budget

Purpose and Scope

The cash budget is designed to determine whether sufficient cash will be on hand throughout the budget period to meet requirements. Early forecasts of the need for cash borrowings can often facilitate such financing and thus forestall the necessity of curtailing production and expansion plans.

The budget is divided into two parts, the first part covering an estimate of cash receipts, and the second an estimate of cash disbursements. A comparison by periods, of the budgeted receipts and disbursements will indicate when additional funds will be needed or when an excess of funds will be available for the reduction of obligations.

Estimating Cash Receipts

Cash receipts for the A Manufacturing Corp. arise principally from collections on accounts receivable, since all sales are sold on credit. A study of cash receipts of prior periods indicates that on the average, a given month's billing is collected as follows:

In the month billed..............	3%
In following months:	
First month	30
Second month	27
Third month	18
Fourth month	12
Fifth month	5
Sixth month	3
Seventh month	2
	100%

These rates of expected collection are applied to the accounts receivable at December 31, 1950 and to each month's sales after provision for uncollectible accounts. Accounts receivable at December 31, 1950 were $ and the allowance for bad debts was $, aged as follows:

Month in which billed	Receivable	Allowance
May, 1950		
June		
July		
August		
September		
October		
November		
December		

The monthly provision for bad debts, based upon experience is computed at 2% of sales. The monthly collection schedule on accounts receivable is, therefore, calculated by distributing 98% of sales for each month on the basis of the estimated monthly collection percentages.

Computation of Estimated Collections

The computation is made as follows:

	Amount	Less, allowance for bad debts	Balance to be collected	Jan.	Feb.	Mar.	April	Etc.
Accounts receivable, 12/31/50:								
May sales								
June								
July								
etc.								
Budgeted sales:								
January								
February								
March								
etc.								
Total								
Less cash discounts								
Estimated collections								

Estimating Cash Disbursements

Cash is required for the following principal expenditures:

Material purchases
Direct labor
Manufacturing expenses
Insurance
Taxes
Selling and administrative expenses
Capital additions
Dividends
Interest

Payment for material purchases:

Most of its vendors sell to A Manufacturing Corp. at cash discount terms if invoices are paid by the tenth of the following month. The company takes advantage of such discounts so that generally all purchases are paid in the following month. The cash required for payment for purchases is calculated as follows:

Month	Purchases, preceding month	Estimated discount	Cash required
January			
February			
March			
etc.			

Cash payments for labor:

Wages are paid on a weekly basis. The cash required to meet payrolls must take into account estimated accruals at the end of each month, as below:

Month	Accrued wages, beginning of month	Monthly labor cost	Accrued wages, end of month	Cash Required
January				
February				
March				
etc.				
	______	______	______	______
	======	======	======	======

Cash required for manufacturing expenses:

To determine cash requirements for manufacturing expenses, the monthly manufacturing expenses as budgeted are adjusted by deducting therefrom all non-cash items. The non-cash items consist of expenses which are customarily prepaid or accrued such as insurance and taxes and items credited to reserves such as depreciation and amortization.

Insurance premium payments:

Examination of the prepaid insurance account will reveal when payments on policies are to be made. After adjustment for coverage and premium revisions, the prior year payments may be used to determine cash requirements.

Tax payments:

Prior year tax payments may likewise be used as the basis for estimating cash requirements. Recognition must, of course, be given to revisions of tax rates and changes in tax bases in calculating the amounts of tax to be paid.

Cash required for selling and administrative expenses:

As in the case of cash required for manufacturing expenses, the selling and administrative expense payments are determined by subtracting non-cash items from budgeted expenses.

Capital additions:

The cost of plant expansion as well as regular replacement of machinery and equipment should be scheduled to determine when the cash in payment therefor will have to be available.

Dividend payments:

Estimated dividend payments should be determined by the Board of Directors based upon forecasts of earnings. The company's established dividend policy should also be considered.

Interest payments:

Cash payments of interest are required in accordance with the terms of the indebtedness agreement. Reference should be made to these documents to determine time and rate of payment. In calculating the interest to be paid, consideration should be given to the necessity for additional borrowings to meet cash requirements and to the possibility that prepayments may be made.

Financing Cash Deficits

A comparison of monthly budgeted cash receipts and disbursements will indicate whether the cash balance is adequate as follows:

	Receipts	Dis-bursements	Excess	Deficit	Cash balance or deficit
Balance, December 31, 1950...					
January					
February					
March					
etc.					

It was determined that a minimum cash balance of $ should be maintained. Reductions in outstanding indebtedness may be made to the extent that the cash balance exceeds the minimum balance. Additional financing is required to the following extent:

Maximum cash deficit.....	
Desired minimum balance..	
Payments on maturing indebtedness	
Total	

	Total	Jan.	Feb.	Etc.
Balance, beginning of month........				
Receipts:				
Accounts receivable				
Additional financing				
Total				
Disbursements:				
Material				
Labor				
Manufacturing expense				
Insurance				
Taxes				
Selling and administrative expense				
Capital additions				
Dividends				
Interest				
Repayment of indebtedness........				
Total				
Balance, end of month.............				

Comparison with Performance

Based upon the various budgets, detailed monthly operating statements are prepared to show anticipated results of operations. When compared with statements of actual operations each month, the budgeted figures show where deviations from the estimated results have occurred. Inquiry into the nature and cause of these variations may disclose:

1) Inefficient operations
2) Changes in uncontrollable factors such as price rises, casualty damage to equipment, etc.
3) Incorrect budget estimates.

Budgets for the succeeding periods, to have any value, should be revised on the basis of the factors discovered to have caused variations in the preceding periods.

Army and Air Force Exchange Accounting

By Horace G. Holley

Background and Objectives of the Exchange Service

Before launching into the subject of Army Exchange Accounting, I would like to give a brief outline of the background and objectives of the Army and Air Force Exchange Service.

Six months before the attack on Pearl Harbor, the Army Exchange Service came into being by fiat of the Secretary of War: "Effective June 6, 1941 there will be organized and established, a separate agency to be known as the Army Exchange Service," announced the War Department order authorizing this new branch of Army Service Forces, then known as Services of Supply.

Nothing new in military history is the idea of a merchant catering to soldiers' needs. As far back as the days of ancient Rome, traders were selling Caesar's legions a variety of wares. Down through the ages, wherever soldiers have gone, traders have followed.

Early in our own history, the presence of soldiers attracted itinerant camp followers who brought, in addition to their wares, corruption and vice. Drawn by easy soldier money were gamblers as well as the common variety of peddlers and the like, who fleeced their victims by giving inferior value at exorbitant prices.

Need for official action was first recognized when Congress passed a reform bill authorizing designated traders or "sutlers" to traffic with military personnel. The protection offered by this bill was all one-sided—on the side of the sutler and not the soldier. These tradesmen were not a part of the Army and could not be controlled effectively in their shady practices. Abolished during the War Between the States, the sutlers were replaced by permanent post traders, who were brought into camps for the purpose of supplying the necessities of Army personnel.

Army Exchanges as we know them today are lineal descendants of the first Post Exchange established by a directive of the Secretary of War, July 25, 1895, which provided for a comprehensive Exchange system, covering every phase of the operation from establishment to liquidation. Although the Post Exchanges of the early days were generally owned and operated by companies stationed at the post, they are remarkably like the present day PX. A span of nearly fifty years and two major wars have not been able to upset their basic policy. That policy which remains today as the foundation of the Exchange Service may be simply stated,

> "To supply the troops at reasonable prices with the articles of ordinary use, wear and consumption, not supplied by

Horace G. Holley is Chief of the Finance and Accounting Branch of the Atlanta Regional Office of the Army and Air Force Exchange Service. During World War II he was General Manager of Fort McClellan Exchange at Anniston, Alabama. Mr. Holley conceived many of the new ideas of operational and accounting procedure set forth in his paper and, because of their successful application in the Atlanta region, they were subsequently adopted on a national basis.

Earlier, Mr. Holley had been associated with a firm of CPAs in Nashville, Tennessee, specializing principally in retail and public utility accounting; also, with the Nashville Trust Company. He is a graduate of Peabody College in that city.

This paper was presented by Mr. Holley at a recent meeting of the Chattahoochee Valley (Ga.) chapter of the N.A.C.A., in Columbus, Ga.

the Government, and to afford them means of rational recreation and amusement."

Regardless of a clear-cut policy upon which every business must stand or fall, the chief shortcoming of this structure was that each exchange operated independently of the others.

Post Exchanges in the early days were independent, small operations with little comparison to today's exchanges. The troops they served were more or less stationary on a post. For that reason, their system of profit distribution, through a share-holding method, was reasonable and adequate to the need. A unit held shares in its exchange proportionate to its strength in relation to the strength of the post. This system had the advantage that profits made on the post remained on the post for the recreational benefit of personnel who had helped create that profit. Such a system can have merit only as long as the personnel remain more or less permanent.

This system continued during the recent war but there were discrepancies noted in its operation that crept in with mobilization and the liquid state of the army. The system of profit distribution gave greater funds to the large posts and penalized the smaller installations. In order to increase profits to the smaller installations, prices had to be higher. Soldiers moving from one installation to another were often amazed to find a difference of four or five cents in the price paid for cigarettes or some similar item.

Price differences were also due to rapid changes in troop strengths at the various posts. To the soldier this was not always apparent and seemed to imply that one exchange was operating more efficiently than another. The truth is that efficiency was not always reflected in price adjustments because these prices were subject to change without notice, based as they were on troop strength and troop demand. Duplication of accountants and bookkeepers was common even though some installations were only a few miles apart.

I have brought out the foregoing historical points to impress upon you the importance of a centralization program which followed in 1946, and to establish a few of the peculiarities of our business.

The concept of centralization was to set up a regional office in each Army Area, having its own accountants, a procurement screening section, and other specialists. This relieved the various exchanges of much tedious bookkeeping and duplication of duties.

Following centralization, which brought with it uniform pricing, and regular dividends for recreational purposes, there evolved, through many stages, an accounting system which is not unlike a retail department store operation, modified to the extent that Army Regulations are complied with.

Accounting Phase of the Operation

The subject you are most interested in is the accounting phase of our operation. I feel it necessary to bring out that through the various stages of development of the Exchange service, the importance of proper accounting methods was more or less ignored. There is always a minimum of paper work that must be done by the branches of any organization to get a true picture, although the hue and cry was to reduce paper work. This was one of the main obstacles that had to be hurdled. This obstacle was overcome by publication of a new manual that spells out every phase of our operation, and by clearer presentation of the financial picture of each installation.

Departmentalization of Operations

Our operation from the selling angle is divided into two types, Retail, and Food and Service. Retail merchandise is divided into nine groups or classes; Tobacco, Candy, Drugs and Sundries, Groceries, Jewelry, Stationery, Clothing, Household Items and Luggage, and Soft Drinks and Beer. On the face it may seem that this is too limited a grouping of retail merchandise units

until it is considered that 45% of our business is done in two of the classes: tobacco, and soft drinks and beer. From a morale standpoint, which we cannot overlook, tobaccos are sold at a very slight markup; thus it is understandable that we operate with one eye on that department.

Purchasing Procedures

It is our policy that buying be done locally if prices are comparable, after consideration of freight and discounts. Therefore, Purchase Orders are issued by the various Exchanges.

After issuance of Purchase Orders, they are sent to the Regional Office for approval. This is done for three reasons: for checking against latest price agreement to see that the prices and terms are in order; for checking against overstock lists; and for checking of the anticipated sales value. Purchase orders are diverted to another vendor if prices charged are not in line.

An "Open-to-Buy" is maintained on each Exchange for purposes of controlling the proper inventory ratio in the departmental classifications. Goal ratios of departmental and total inventory have been established at retail prices based on experience.

"Open-to-Buy", it can be understood, must be flexible and frequently adjusted dependent on troop strength. Frequent shifting of purchasing population is responsible principally for this situation. Here is a major difference between our business and the average retail store.

After approval of the Purchase Order, the Vendor copy is mailed to the vendor. The Accounts Payable copy is delivered direct to the Accounts Payable Section of our Regional Office, for subsequent matching with the invoice and Receiving Report. One approved copy is returned to the Exchange to be used as a basis for receiving merchandise. Invoices are mailed direct to the Regional Office by the vendors.

Receiving and Transfer Procedures

Receiving of merchandise in the Exchanges is accomplished by means of a Receiving Report form. Retail merchandise is received at selling value only, and Food and Service items at cost value. Cost is applied to each transaction applicable to retail departments only at the Regional Office, after matching of the Purchase Order, Receiving Report, and Invoice.

The selling values as shown on Retail Department Receiving Reports, are used as a basis for maintenance of an accountability on the Exchange as a whole. In this connection, it is our intention to expand our accounting program at a later date to include retail branches within each Exchange.

Transfers of merchandise from the receiving entity to the various branches of an Exchange are accomplished by means of a Transfer Voucher form. Except for establishment of a selling value charge against the receiving branch and a selling value credit to the shipping retail warehouse within the Exchange, retail transfers are ignored by the Regional Office. They should zero out daily, however, within the Exchange when summarized, receiving against shipping.

Transfers between Retail and Food and Service branches are priced at Cost and Sell, the Cost ultimately becoming a credit or charge to the respective inventory accounts maintained in the Regional Office.

It is well to remark here that all retail items are price tagged, the tagging including date of receipt for later inventory ageing.

Reporting to the Regional Office

Reporting to the Regional Office is accomplished by means of three principal reports: the Daily Cash and Sales Report, which is prepared for each Retail and Food and Service Outlet; the Daily Retail Merchandise Report, which is prepared for each Retail Outlet; and the Daily Food and Service Merchandise Report, which is prepared for each Food and Service Outlet.

Daily Cash and Sales Report

In introducing the Cash and Sales Report, let me explain that in the recent overhaul of our accounting system to place ourselves on a 100% retail system, we re-equipped all of our retail branches with new cash registers by which sales could be departmentalized. Prior to this time we had arrived at departmental sales by calculation, in which calculation frequent retail inventories were necessary. With the installation of the new registers we now take our official retail inventories annually.

Preceding preparation of the Daily Cash and Sales Report, sales clerks prepare a Sales Clerk's Daily Report as a record of the cash turn-in. This is tied-in with the register readings, by clerk and by department, taken independently by the branch manager. From this data, the Daily Cash and Sales Report is prepared by department. Register tapes are inserted into an envelope on which the register readings are recorded. The cash, representing the sales for the day, the report of sales and the register tapes are then sent to the local Exchange office, of course observing the rules of internal control.

The Daily Cash and Sales Reports of the branches are checked in the Exchange office, the cash counted and balanced against cash register reports. A Summary Report, is then prepared and transmitted to the Regional Office with the branch reports together with a check representing the day's receipts.

Daily Retail Merchandise Report
Daily Food and Service Merchandise Report

The Daily Retail Merchandise Report and the Daily Food and Service Merchandise Report are also summarized and submitted to the Regional Office with the documents representing the various transactions attached, except the transfers between retail branches. The two merchandise reports are in effect a letter of transmittal.

Working Fund Report

There is one more report that flows to the Regional Office: the Working Fund Report. Each Exchange is advanced a sum of money known as the Working Fund which is used for change funds, check cashing, and miscellaneous petty expenditures. This fund is reimbursable upon submission of a Working Fund Report with petty cash tickets and copies of checks written against the funds, attached. The Working Fund Report is in form similar to a disbursements register and is also used as the Exchange officer's record of bank balance. Bank statements and Working Fund cancelled checks are mailed direct to the Regional Office by the bank for reconcilement.

Regional Office Procedures

Daily Cash and Sales Report

Now that we have all the necessary accounting documents delivered to the Regional Office, let us go back to the Daily Cash and Sales Report. These reports are tested for accuracy of entries and extension. Every item on the report, with exception of the cash sales, is supported by a document, either a cash receipts voucher identifying the item as a customer deposit on Lay-Away Sales, Concession Receipts, or Accounts Receivable Collection, or a charge voucher representing a charge sale to some organization. The various documents, after checking work is completed, are separated from the report and sent to the proper department for entry on the detailed records.

The Summary of Daily Cash and Sales Report is then sent to the IBM Room for card punching by classification of sales or type of miscellaneous receipt. Thus, we build up our Cash and Sales Summary for easy posting at the close of the month. The retail sales, IBM cards, after a summary card is punched by retail classification, by Exchange, are reproduced into the "decrease" field of a Retail Inventory Card, the use of which I will discuss later.

Daily Retail Merchandise Report

The Food and Service end of our business seems unglamorous to me from an accounting standpoint so I am assuming that it will be the same to you. Therefore, I will take you through the processing of the retail transactions evolving from the Daily Retail Merchandise Report, and leave the rest to your imagination.

Receiving Reports: Receiving Reports, after being detached from the merchandise report, are sent to an Accounts Payable Control Clerk by batch, and then to the IBM Room where a card is punched recording the receiving report number, the Purchase Order number, the Exchange number and the total retail value. A tabulation is made, balanced with the Control Record and then the Receiving Reports are distributed to the Invoice Matching Clerks who handle the transactions of certain designated exchanges.

The Receiving Reports are matched with the Purchase Order, vendors invoice, and any shipping documents that might be on hand. Each vendor has a code number which has been applied previously to the Purchase Order copy by coding clerks. After matching of the documents, a distribution ticket or invoice apron is attached to the papers and account numbers applied.

The grouping of unprocessed papers is maintained by Exchange at all times, so that when they finally reach the key punch operators, considerable reproduction steps may be used.

Groups of matched documents are returned to the Control Clerk where a batch number is assigned, and totals recorded prior to delivery to the key punch operators.

Accounts Payable Cards: Distribution cards are punched from the information shown on the invoice apron, from which Accounts Payable cards are reproduced. In case there is a multiple distribution a summary Account Payable card is prepared at once by the Key Punch Operator. This has been found to be a satisfactory method at present; however, we propose later to employ automatic summary punching.

The distribution cards are summarized monthly, by Exchange and merchandise classification, and the retail values reproduced into an "increase" section of a Retail Inventory Card. Throughout these steps a transaction code number is applied by gang punching for identification.

Monthly Subsidiary Ledger cards are then reproduced from the Distribution Summary cards, tabulated, and turned over to the General Bookkeeper.

The Accounts Payable cards are prelisted on the tabulator and hand matched against vendor debit balance cards. Debit balance cards are hand sorted-in if the listing indicates that a payment is to be made to the vendor. New debit balance cards, which generally represent returns to vendors, as indicated by the listing, are hand pulled with the credit cards and placed in the debit card file, where the debit card amounts exceed the credit card amounts.

Checks: Following this step, vendor name and address cards are merged with the Accounts Payable cards and checks are prepared on the tabulator. Checks are prepared in triplicate, the two copies serving as a document to file with the applicable invoices, and as a numerical file of checks written.

During the process of printing of the checks, total cards are prepared for use as a check register, and subsequent matching with cards punched for cancelled checks, to prepare a record of outstanding checks.

Freight Charges: One problem had to be worked out during the process of changing our system, which was caused by the fact that a large proportion of our freight charges are paid through the Working Fund. The payments had to be analyzed in order that the proper retail classification would be charged, and this was a tedious manual operation that caused delays. This was solved by providing a box

in the Receiving Report to enter the amount of cash payments for freight and express made from the Working Fund, and a box on the Invoice Apron to record "Transportation not shown on invoice".

"Transportation not shown on invoice" is punched into a prepared field of the invoice distribution IBM card but is not reproduced into the Accounts Payable card. In this manner, the freight charge is applied to the proper inventory account. An off-setting distribution is provided by preparation, by reproduction methods, of a "transportation" card, and the total as shown by tabulation is credited to the freight and express expense account. The total of all freight and express paid from the Working Fund may then be charged in a lump sum to the freight and express account without analysis and the residue left in the account represents the unallocated items. Another major advantage of this system is that total original cost of merchandise is obtained from one source. It might occur to you that this system could be highly inaccurate, but it must be remembered that there is a shipping document attached to the Receiving Report for easy reference at the time the Invoice Apron is prepared.

Transfer Vouchers: As I have explained to you previously, Transfer Vouchers to be handled in the Tabulating Machine Unit do not include transfers of retail department merchandise between the retail branches. This type of transfer represents internal department movement only and, therefore, it is not necessary until such time as it is decided to maintain separate retail department inventory records for the individual retail branches.

Therefore, the types of transfers we are concerned with are the transfers from retail to cost department within the exchange, transfers between exchanges of our own region, and transfers between exchanges of other regions.

The aforementioned transfer vouchers are also processed through the IBM Section; however, in this process we pass only the vouchers representing the "transfers out." Debit and credit account numbers are punched in to the cards directly from the "transfer out" vouchers. The cards are then reproduced, in which operation the "Account to be Credited" and the "Account to be Charged" fields are reversed, dropping a credit "X" which has been punched originally, as well as the transaction code number applicable to this type of transaction. Both sets of cards are then interpreted for visual identification. Retail value has been maintained throughout these steps, as well as the cost value.

The original copies of the Transfer Vouchers representing "Transfers in" are held in a file in numerical sequence, by branch, by exchange. The interpreted IBM cards are then manually matched against the "transfer in" vouchers with the result that unmatched cards or unmatched vouchers represent merchandise in transit, debit or credit.

Retail merchandise punch cards are then reproduced from the transfer cards, using either the "Decreases in Inventory" or "Increases in Inventory" fields, as the case may be.

Price Change Vouchers: It will be noted that retail inventory cards are being gradually accumulated from the various transactions, to the point that only the price changes are left to complete a retail inventory record. Also it is to be noted that the cost and sell price of the various transactions have remained intact in the distribution cards to be used in later calculation of "Mark-on" percentages.

Price Change Vouchers are also handled by punch cards, using a credit "X" for mark-down. Detail Price Change cards are summary punched into retail inventory cards.

We have now worked down to the point where we are in a position to use the data we have been accumulating through various stages.

The Distribution Journal: Our first step to putting all of this material together is to prepare, in summary form, a Distribution Journal by exchange, by account number. From this journal, which is also broken down into merchandise classifications where inventories are concerned, we are now able to calculate our "mark-on" percentages for application to the classified retail sales to obtain the Cost of Sales.

Mark-on percentages are maintained on a cumulative basis for the fiscal year from July 1 through June 30, and every type of transaction involving retail inventory is used in the computation.

Merchandise Losses: Provision for shrinkage has been established at the rate of ½ of 1% per month and deducted from the computed gross profit; however, in preparation of the retail inventory record, this shrinkage is not considered. This probably would not be considered in good taste by many of you but we still have a traditional barrier, another peculiarity of our business, to break down, that being an emphasis on merchandise accountability. However, with institution of "self service" departments in our main stores, our trend toward a liberalization of this idea may be noted together with education along the lines of thought that a store should never be closed for inventory.

Accounting Statements

We finally wind up by publishing two principal statements, one for Retail Department Operations, in which Net Sales, Markdowns, Provision for Shrinkage, Cost of Sales and Gross Profit are presented for the current month and year-to-date with a memo of "Closing Inventory at Retail" by merchandise classes, and an Exchange Operating Statement, in which the over-all results are presented currently and year-to-date as to Retail Branches, Food and Service Branches and Total of all Branches.

Budgets

In 1949, the importance of budgeting was recognized and employed, and later expanded, both in merchandising and expense lines. As a result, profit and loss and merchandise budgets are prepared monthly in advance and submitted to the Regional Office. Comparisons are made with actual results, which seems to have created an incentive to meet the goals the exchanges have themselves established.

Payroll Accounting

All salaries are paid from the Regional Office, using punch card methods. Time cards are submitted biweekly by the exchanges, and the hours as shown thereon are transferred to a master payroll punch card which has been reproduced from the previous payroll period and contains the basic hourly rate and overtime rate, with the hours worked omitted. The cards are processed through a multiplier for calculation of base pay, overtime pay and gross pay. Any changes in base pay must be authorized prior to the opening of the next payroll period; therefore, rate changes are generally made before time cards arrive.

As most of our people are on a 40 or 48 hour work-week, deductions are fairly standard and deduction cards at present need be changed only when the work week varies or the pay rate changes. With the apparent later application of Federal Old Age Benefit taxes to Exchange Service employees, it is likely that a change will have to be made in the system to distinguish between fixed and variable deductions.

Deduction cards are merged with the Master Payroll cards, using the employee number as the merging medium, and then a Payroll Register is prepared, by exchange, by branch and by account number, showing all hours, regular pay, overtime pay, annual or sick leave pay, deductions itemized, and net pay. Following this step, payroll checks are prepared on the Tabulator.

"To-date" Payroll records are prepared following each payroll period, by merging of previous to-date payroll cards with current cards and producing a new to-date card. End-of-month payroll accrual is prepared by multiplying the regular pay, as shown by the master payroll cards for the immediately preceding payroll period, by a factor representing the number of work days from the close of the last payroll period of the month to the end of the month, in relation to the total number of work days in the month. This is an entirely mechanical operation through reproduction and use of multiplier, and is broken down into branch and account numbers by exchange.

A summary tabulation is run at the close of each month for posting purposes which includes regular pay (including sick leave pay, overtime pay, and annual leave pay paid during the month) plus the current accrual, less prior month accrual, arriving at the net charge to payroll expense.

The payroll bank account is handled on an imprest basis and "net" figures are passed through a payroll clearing account.

Fixed Asset Accounting

Fixed asset records are also handled at the Regional Office on IBM punch cards. Each asset is assigned a number and cards are interpreted for easy reference. Periodically, lists of fixed assets are run for checking purposes.

Other Functions

The Regional Office performs a number of other functions for the various exchanges, such as handling of claims, retirement records, group insurance, bonding of employees, and comprehensive insurance coverage.

National Headquarters

I have purposely avoided mentioning the Central Headquarters of Army and Air Force Exchange Service, in New York, until this moment, not because of its lack of importance to us, but because I have tried to present a picture to you from the ground up.

In Headquarters, Army and Air Force Exchange Service in New York, our accounting policies are established on a nation-wide basis. It so happens that most of these policies have been tried out in this region, which we have considered a rare compliment. The ideas of any employee in any region are given due consideration, and we believe that we now have a firm foundation which cannot be basically changed, but is still open for expansion and improvement.

An Inter-office account is maintained between the Regional Offices and the New York office in order to eliminate the necessity of passing cash back and forth for transfers between the regions, or remitting of retirement contributions.

The financial statements of all regions are consolidated on a national basis by the New York office and passed on to Washington. Comparative statements and statistical data are prepared monthly.

AN ADIRONDACK VIEW

It's Simple. A truck driver identified the mysterious melody on the radio as "The Blue Flag." It was simple—even the title. Perhaps he knows all the old tunes—more likely he can't tell one from another. But it was simple—the title had been broadcast and published for two weeks. Probably even some CPAs knew it.

Now-a-days the car shifts itself; the gasoline pump quits when the tank is full; instead of left arm semaphore wig-wags, you use the directional signal lever; the jack simply goes under the bumper; the engine starts when you turn the key; et cetera.

In the large accounting office the punched sales cards are thrown into a machine; Bill Jones' sales of buckwheat, in Utica, during May, are sorted out; when put into another machine, they are listed and added. Pretty simple compared to hand sorting and head adding!

But human relations get more complex. Perhaps we better take Micah to heart or haul out the Golden Rule and put it to work.

LEONARD HOUGHTON, CPA
Of the Adirondack "Chapter"

The "Funds" Statement

By John N. Myer

For some thirty years numerous articles have appeared in accounting magazines with respect to the so-called "funds" statement. The discussion has usually been confused because the use of the word "funds" in connection with this statement has been variously interpreted as meaning resources, working capital, or cash, and this has caused uncertainties with respect to the purpose of the statement.

It seems to the writer that the reason for constructing the statement under discussion is usually that of providing something in the nature of a review of the financial events which have occurred in a business enterprise during a certain period of time, usually a year. This is done by using either the capital, the working capital, or the cash as a basis and making a summary of the causes of the changes on that basis. Calling the statement a "funds" statement has focused attention on the means rather than the end with the result that the statement is commonly regarded as a sort of reconciliation of the capital, working capital, or cash, as the case may be, at the end of a period with that at the beginning.

Since either (1) capital, (2) working capital, or (3) cash may be used as the basis for compiling the statement, there are three different kinds of "funds" statements possible, all of which give similar information but in somewhat different form.

John N. Myer, M.S., is Assistant Professor of Accountancy in the School of Business and Civic Administration of The City College of New York. He is also Coordinator of the Program in Accounting in the Management Institute of the Division of General Education, New York University. He has for some time specialized in the field of accounting interpretation and is the author of "Financial Statement Analysis."

Illustrative Case

Using the hypothetical case of the partnership of Allen and Briggs whose position statement and income statement are shown in Exhibit I, there have been compiled the three types of statements shown in Exhibits II, III, and IV. (See pages 354-356.)

Exhibit II shows the statement which results when net resources or capital is used as the basis for its preparation. This statement is derived from the position statement data by tabulating the increases and decreases of the assets and liabilities.

Exhibit III shows the resulting statement when the financial changes are compiled by using working capital as the basis. In preparing this statement both the position statement and income statement data are used. A work sheet such as is illustrated in textbooks for this purpose may be employed.

Exhibit IV presents the statement as constructed when it is compiled on the basis of the effect of the financial events on the cash.

Comparison of the Three Statements

The statement on the capital basis is least informative. In fact, it is but a rearrangement of the "changes" column of a comparative balance sheet. This method is used when only the balance sheets are available with no further information. When data on operations and other activities are available either the working capital or cash basis is to be preferred.

It is seen that the differences between the statements on the working capital basis and the cash basis are

(Text continued on page 358)

Exhibit I-a: Position Statement

	December 31, 1950		December 31, 1949	
Current Assets:				
Cash		$ 5,350		$ 4,261
Accounts receivable	$15,832		$13,154	
Less—Allowance for bad debts	150	15,682	125	13,029
Merchandise inventory		21,687		19,850
Prepaid expenses		675		852
Total current assets		$43,394		$37,992
Less—Current Liabilities:				
Notes payable—bank		$ 7,500		$ 3,000
Accounts payable		8,823		9,051
Accrued liabilities		274		385
Total current liabilities		$16,597		$12,436
Working capital		$26,797		$25,556
Equipment:				
Furniture and fixtures	$18,285		$17,684	
Less—Depreciation	5,082	$13,203	3,240	$14,444
Delivery truck	$ 5,000		—	
Less—Depreciation	500	4,500	—	—
Total equipment		$17,703		$14,444
Partners' equity		$44,500		$40,000
Represented by:				
Allen, Capital		$22,250		$20,000
Briggs, Capital		22,250		20,000
		$44,500		$40,000

Exhibit I-b: Income Statement for the Year Ended December 31, 1950

Sales		$86,750
Cost of Goods Sold:		
Inventory, January 1	$19,850	
Purchases	47,193	
	$67,043	
Inventory, December 31	21,687	
Cost of goods sold		45,356
Gross profit		$41,394
Expenses:		
Selling, general and administrative expenses	$27,361	
Depreciation of furniture and fixtures	2,192	
Depreciation of motor truck	500	
Provision for bad debts	125	
Interest cost	405	30,583
		$10,811
Other Income:		
Sale of furniture		139
Net income		$10,950

Exhibit II: "Funds" Statement on Capital Basis

Capital, January 1, 1950			$40,000
Capital was Increased By:			
Increases in assets:			
Cash	$1,089		
Accounts receivable	2,678		
Merchandise inventory	1,837		
Furniture and fixtures	601		
Delivery truck	5,000	$11,205	
Decreases in liabilities:			
Accounts payable	$ 228		
Accrued liabilities	111	339	
Total of changes increasing capital			11,544
			$51,544
Capital was Decreased by:			
Decreases in assets:			
Prepaid expenses		$ 177	
Increases in liabilities:			
Notes payable—bank		4,500	
Increases in deductions from assets:			
Allowance for bad debts	$ 25		
Allowance for depreciation of furniture and fixtures	1,842		
Allowance for depreciation of delivery truck	500	2,367	
Total of changes decreasing capital			7,044
Capital, December 31, 1950			$44,500

Exhibit III: "Funds" Statement on Working Capital Basis

Working Capital, January 1, 1950		$ 25.556
Working Capital Was Increased By:		
Sales	$86,750	
Sale of furniture	664	
Additional investment by partners	4,000	91,414
		$116,970
Working Capital Was Decreased By:		
Cost of goods sold	$45,356	
Selling, general and administrative expenses	27,361	
Bad debts provision	125	
Interest cost	405	
Withdrawals by partners	10,450	
Purchase of furniture	1,476	
Purchase of truck	5,000	90,173
Working Capital, December 31, 1950		$ 26,797

Exhibit IV: "Funds" Statement on Cash Basis

Cash Balance, January 1, 1950			$ 4,261
Cash Was Increased By:			
Sales		$86,750	
Sale of furniture		664	
Loan from bank		7,500	
Additional investment by partners		4,000	
		$98,914	
Less—Increase in accounts receivable		2,778	96,136
			$100,397
Cash Was Decreased By:			
Purchase of goods for resale		$47,193	
Selling, general and administrative expenses		27,361	
Interest cost		405	
Withdrawals by partners		10,450	
Purchase of furniture		1,476	
Purchase of truck		5,000	
Repayment of bank loan		3,000	
		$94,885	
Add—Decrease in accounts payable	$228		
Decrease in accrued liabilities	111	339	
		$95,224	
Less—Decrease in prepaid expenses		177	95,047
Cash Balance, December 31, 1950			$ 5,350

(Text continued on page 358)

Cases and Points on Professional Ethics

Refusal to Furnish Tax Returns to Clients and Related Matters

During the tax season, a number of complaints were received regarding the refusal of some accountants to furnish copies of tax returns or return books of account to former clients. This situation usually arises when a client changes accountants and the supplanted accountant permits his feeling of pique to prevail over his better judgment. The action of the accountant cannot be condoned in view of the long-standing pronouncement issued by the Board of Directors on June 21, 1945, stating as follows:

"The Committee on Professional Conduct has received inquiries from former clients of members as to whether they are entitled to receive from their former accountants, file copies of tax returns or other documents prepared for submission to federal, state or municipal taxing or regulatory authorities, if they have at no time received such copies from the accountant during the course of the engagement.

"It is the opinion of the Committee that the failure to provide copies of such returns is discreditable to the members concerned, embarrassing to business men and constitutes a violation of the final paragraph of the Rules of Professional Conduct as set forth in Article XVIII of the By-Laws.

"In case an accountant has supplied a former client with copies which have been lost or mislaid by such client, it is the opinion of the Committee, that the accountant, upon request of the client, should supply copies of the returns and may make a reasonable charge for the actual time required to prepare the copies.

"It is hoped that this general statement will make it unnecessary for the Committee to act on specific complaints."

In most cases, compliance follows when the Committee calls attention to the Board's pronouncement on the subject. Although not specifically covered by the Board's statement, an accountant is likewise duty-bound to return books of account and documents belonging to his former client. It is the opinion of the Committee that an accountant should permit his successor to inspect and make copies of such work papers and documents as may be in his possession relating to the former client's tax returns or other documents filed with the federal, state and local taxing and regulatory authorities. This is deemed desirable not only as a matter of public interest in maintaining proper accountant-client relations but also for the purpose of fostering co-operative professional relations between members of the Society.

Solicitation of Clients by Former Employees

Rule 9 prohibits solicitation of clients directly or indirectly; however, it does not bar an accountant from discussing a possible engagement and accepting such engagement with a client who broaches the subject without any solicitation on the part of the accountant. The crucial point is who made the initial overture to undertake the engagement—the accountant or the client.

In most of the complaints alleging solicitation, the facts indicate a stereotyped pattern of behavior. An accountant quits his job, opens his office, and, presto, clients of his former employer beat a track to his office and importune him to take over their accounting work. Explanations of this character are naturally viewed with skepticism and

are closely scrutinized by the Committee.

When an accountant is approached by a client of his former employer, it is a matter of elementary courtesy that the accountant should inform his former employer of the circumstances so as to dispel any doubt as to who took the initiative in bringing about the change in accountants.

In passing, it may be observed that it is usually the small practitioner who prefers charges of solicitation against a former employee. The small practitioner working under considerable pressure frequently neglects to maintain periodic contacts with his client, entrusting this important responsibility to staff members in whom he reposes confidence. In many instances, it is not so much the loss of the client that is the moving cause of the complaint as the feeling of betrayal by a trusted employee.

The "Funds" Statement

(Continued from page 356)

few indeed. These differences are as follows:

(1) The statement on the cash basis shows the cost of the goods purchased for resale since cash is decreased by the purchase price of all goods purchased whether sold or not, whereas the statement on the working capital basis shows the cost of the goods sold as decreasing working capital.

(2) The provision for bad debts decreases the working capital whereas it does not affect the cash.

(3) Although the bank loans affect cash they do not affect working capital since they represent an interchange between working capital items.

(4) The statement on the cash basis requires consideration of the changes in the balances of accounts receivable, accounts payable, and prepaid expenses in order to adjust the data to the cash basis.

Evaluation of the Statements on the Working Capital and Cash Bases

It is the opinion of the writer that in general the statement on the working capital basis is preferable to that on the cash basis for the following reasons:

(1) It has been argued in some quarters that the reader of the statement may not know the meaning of the term *working capital* whereas everybody knows the meaning of *cash.* This argument is not impressive since most business men understand the significance of the term *working capital.* Also, the argument is weakened by the growing popularity of the "position statement" form of balance sheet in which the working capital appears as a sub-total. In such case the statement under consideration becomes a useful supporting schedule.

(2) The adjustments for the increases and decreases in the accounts receivable, accounts payable, and prepaid expenses tend to complicate the statement on the cash basis to such an extent that it is certainly less understandable than that on the working capital basis. These complications would increase if in a particular case there were income to be accrued and to be deferred. The statement on the working capital basis presents a simple list of causes of increase and decrease in the working capital.

(3) The working capital basis being a broader one, the statement which employs that basis is fundamentally more consonant with the accrual basis of accounting and with the concept of a continuing business than that on the cash basis.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Survey of State and Local Taxation, 1949-1950

For a number of years the New York University Law Review has been devoting one issue each year to a Survey of New York Law in all its phases. One phase, of course, is State Taxation. Significant changes in tax law, legislative and judicial, are reviewed in the December, 1950, issue of the Law Review by Jerome R. Hellerstein, Assistant Professor of Law at the New York University School of Law and an editor of the Tax Law Review.

Marital Deduction

The only significant change in tax policy during 1950 was the adoption of a marital deduction for estate tax purposes. This is patterned after the federal provision introduced in 1948. Professor Hellerstein feels that the marital deduction has no proper place in the state estate tax, "except as a political device for reducing estate tax rates on larger estates without giving the appearance of favoring wealthier decedents." This is a debatable issue in the light of the inequality of treatment of residents in non-community property states as compared with those in community property states. It should be noted that the marital deduction serves to reduce the $20,000 exemption for bequests to a surviving spouse. In that respect (to the extent of $20,000) estates do not effect any savings as a result of the marital deduction.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving on the Society's Committee on Federal Taxation, and is Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Sale of a Residence

The legislature, in 1950, changed the basis for determination of a gain or loss resulting from the sale of a residence by eliminating an adjustment to the basis for depreciation. This was an equitable change, since depreciation on a residence is not an allowable deduction. This change conformed the state law with the federal law so far as gains are concerned. The state law is more liberal than the federal law with respect to losses. These are deductible as capital losses under state law, but not under federal law. It is of interest to note that a bill has been introduced in the 1951 legislature to disallow a deduction for a loss on the sale of a residence. Up to the present writing, no action has been taken on the bill.

Gross Receipts Tax—Interstate Commerce

The 1950 legislature modified the authority of New York City under the gross receipts tax, to tax out-of-state vendors that have no offices in the city, but sell through manufacturers' agents, independent sales agencies or resident salesmen.

The author points out that the Comptroller appears to be defying the view

that the legislature intended to free such sales from the gross receipts tax. In a letter of the Comptroller dated July 5, 1950, he states that even under the amended law, the gross receipts tax is applicable to receipts of persons who make sales through manufacturer's agents, sales agencies, or resident salesmen, even though the taxpayer maintains no office within the City of New York. It had been estimated that the amendment, if it accomplished what it intended to do, would save taxpayers a million dollars a year in taxes.

Corporate Franchise Taxes

Section 187 (1-3) of the Tax Law imposes a franchise tax on domestic and foreign insurers for the privilege of doing business in New York. The tax is measured by "direct premiums . . . on risks located or resident in this state." Direct premiums include those paid on property, or risks located in this State (including premiums for reinsurance assumed); and premiums "received in this state on business which cannot be specifically allocated or apportioned and reported as taxable premiums on business of any other state." This provision in the law was in issue in a recent case.[1] The insurance company received life insurance premiums on policies of persons living in states where the insurance company was not authorized to do business. Some of the premiums were received at agencies located outside the State of New York and then transmitted to the New York office. The insurance company argued that such premiums were not taxable in New York since they do not constitute premiums received in this state. The court held that the premiums were received by agents of the company outside the state and the proceeds ultimately came into possession of the company in this state.

There was another question with respect to reinsurance premiums. Such risks were originally written by other companies, this company merely reinsuring a portion of the risks. The company argued that it was liable for the tax only on reinsurance risks related to persons or property located in New York. The Court held that the tax applied to reinsurance premiums on non-resident risks, since the reinsurance contracts were written and accepted in this state and further that the reinsurance premiums were not taxed in any other state. The author of the article questions the correctness of the decision as it relates to the reinsurance premiums. He observes that the direct premiums for the insurance were probably taxed in full by the original insurer's state and the result of this decision produces a double tax by two states.

Sales Tax

A recent case[2] again raised the question of the applicability of the sales tax to art work and photographs, created by the artist or photographer, for the publisher and advertiser who uses the artist's material for advertising purposes or in the illustrations of stories. A license to use artistic products is subject to the sales tax when transferred to a publisher or advertiser, even though the value of the work is attributable to highly skilled services. In the instant case, the taxpayer was a photographer who delivered prints to Conde Nast publications which had merely the first right to reproduce. Under the arrangement with the photographer, the prints were returned. The publications never had title to the prints. Under those circumstances, the Court held the sales tax inapplicable.

The Court distinguished an earlier case[3] where the vendee had dominion over the prints. It could retouch them, correct or destroy them and in fact failed to return most of them. The

[1] *Guardian Life Ins. Co.* v. *Chapman*, 276 App. Div. 88 (3rd Dept., 1949).
[2] *Frissell* v. *McGoldrick*, 300 N. Y. 370 (1950).
[3] *Howitt* v. *Street & Smith Publications*, 276 N. Y. 345 (1938).

Court draws a line based upon technical ownership of the prints, their return and the manner in which the vendee uses them. The author of the article disagrees with the decision. He feels that a premium is placed upon niceties of legal title and other issues that lack reality.

In the case of *Seeth* v. *Joseph*[4] the court exempted from the New York City Tax a Sandy Hook pilot who piloted vessels engaged in interstate and foreign commerce, following the holding in *Joseph* v. *Carter & Weeks Co.*[5] to the effect that a tax on conduct of the stevedoring business in the Port of New York infringed the interstate and foreign commerce clauses of the federal Constitution.

In the case of *City of New York* v. *Bernstein*[6] the City sought to collect a sales tax from an officer of a defunct vendor corporation. The statute imposes a personal liability on a corporate officer for failure to collect the tax from consumers and paying it to the City. The court however did not permit a recovery under this section. Thereupon the city brought suit[7] against the same officer for the corporation's liability to collect and pay the tax. This time the Court granted summary judgment, apparently refusing to follow its earlier decision.

Income Tax

The author comments on the case of *Carpenter* v. *Chapman*,[8] wherein the Court held that a non-resident attorney, whose sole office was located in New York, could not allocate his income outside the state because he did some of the work at his home in New Jersey or at his farm in Vermont. The author thinks this is a sound result. If an allocation were granted, income would escape state taxation. The business is conducted out of the single office in New York. The result could be otherwise if the attorney also had an office in the domiciliary state. This would of course mean that the attorney would have to be admitted to practice in the other state.

The author calls attention to the opinion of the Attorney General[9] that approves the practice of the State Tax Commission in not taxing a grantor on income of a revocable trust. The Tax Commission does not follow the doctrine of *Helvering* v. *Clifford*[10] which taxed the grantor on the income of an irrevocable, short term family trust, with substantial control over the corpus retained by the grantor. The Attorney General believes that any change in the taxation of trust income should come from the legislature.

Unincorporated Business Tax

Since income from the practice of a profession may be exempt from the unincorporated business tax, it is amazing how many taxpayers struggle to come within the classification of profession. One persistent taxpayer, who was a professional consultant in matters relating to corporate finance and reorganizations, felt that he belonged in the favored exempt group. The Court[11] didn't see it that way. The taxpayer's skill was not from formal schooling, but through business experience. Quoting from the *Tower* case[12] the Court said, "the practice of a profession requires knowledge of an advanced type in a given field of science or learning gained by a prolonged course of specialized instruction and study."

[4] 276 App. Div. 188 (1949).
[5] 330 U. S. 422 (1947).
[6] 193 Misc. 224 (1948).
[7] 90 N. Y. S. (2d) 759 (1949).
[8] 276 App. Div. 634 (1950); see also New York State Tax Forum, August, 1950, p. 495.
[9] December 27, 1949; see also New York State Tax Forum, April, 1950, p. 239.
[10] 309 U. S.—331 (1940).
[11] *People ex rel. Moffett* v. *Bates*, 276 App. Div. 38, aff'd. 301 N. Y. 597.
[12] 282 N. Y. 407 (1940).

This taxpayer attacked the constitutionality of the unincorporated business tax. He contended that the law infringed the due process clause, since he had a natural right to engage in business and the state could not tax the exercise of that right. He also invoked the equal protection clause of the State Constitution claiming that exemptions under the statute constituted a discrimination. The Court rejected both contentions. The Supreme Court of the United States denied a writ of certiorari.[13]

Very recently, a realty appraisal expert sought exemption from this tax[14] on the ground that he belonged to an exempt profession. He claimed to be a valuation expert who was equipped to handle complex problems relating to the evaluation of real property by reason of specialized study and knowledge. But the Court did not think that expertness makes one a member of a profession.

Estate Tax—Reopening the Entry of an Order Assessing the Tax

The executors of an estate[15] had filed a petition to fix the tax. On the basis of the petition a pro forma order was entered and the tax paid. One and a half years later the executors sought to reopen the order claiming an overpayment of the tax. Certain errors were discovered after an audit of the federal estate tax return. Assets had been over-valued, previously taxed property had been improperly included, and executors' commissions and counsel fees were incorrectly stated. The State Tax Commission opposed the application on the ground that the taxing order had become final.

The Court permitted the reopening of the order on the ground that section 20(b) of the Surrogate's Court Act permits a reopening within two years from the entry. This section deals with fraud, later discovered evidence, clerical error, "or other sufficient cause." An interesting point in the decision is the comment of the Court that it did not have the power to direct a refund. The Court went so far as to suggest that the matter should be brought to the attention of the legislature. It suggested amendments to sections 225 and 249 (a) (a) in four particulars: (1) consolidate and clarify the present overlapping and ambiguous provisions in both sections; (2) authorize adjustments by direct negotiation between the taxpayers and the State Tax Commission; (3) expressly provide that taxpayers be permitted a period of two years within which to take steps for obtaining relief; (4) provide that Surrogate's Courts be vested with jurisdiction to direct warranted relief.

Interest on Tax Claims in Insolvency Proceedings

The United States Supreme Court has held[16] that in a federal bankruptcy proceeding interest on tax claims stops with the date of the filing of the petition in bankruptcy. The Appellate Division for the First Department has recently held[17] that federal and state statutes applicable to insolvency proceedings require the allowance of interest on tax claims where there has been an assignment for the benefit of creditors. The Court holds that the Chandler Act Amendments to the Bankruptcy Act are not applicable in insolvency proceedings.

Resort to Federal Courts

An interstate trucking company brought an action against the City of

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[13] 71 Sup. Ct. 88 (1950).

[14] *Application of Adelberg,* New York Sup. Ct., App. Div.—3rd Dept., 102 N. Y. S. 2d 44 (1951).

[15] *In re Ford's Estate,* 96 N.Y.S. 2d 177 (Surr. Ct., Broome Co., 1950).

[16] *City of New York* v. *Saper,* 336 U. S. 328 (1949).

[17] *In re: General Assignment of Pavone Textile Corp.* (App. Div., 1st Dept., 1950).

New York[18] for a declaratory judgment that the New York City Gross Receipts Tax could not be applied to its business. The complaint was dismissed on the ground that the tax appeared prima facie to be valid in view of the apportionment provisions in the act. The taxpayer then sued in the federal court. This time the Court held[19] that the taxpayer had failed to exhaust its administrative remedy. He should first have asked for a hearing before the Comptroller and there sought an adjustment of his grievances before seeking judicial action.[19] We can understand the taxpayer's desire to circumvent the normal procedures.

Statute of Limitations

Sec. 195 requires the Tax Commission to audit a franchise tax return within five years after a return is filed. This section relates to corporations taxable under Article 9. A similar provision (Sec. 212) is contained in Article 9A relating to business corporations. The recent legislature amended these sections to provide that a report filed before the last day prescribed for the filing shall be considered as filed on such last day. This amendment is effective as of February 17, 1951.

Unincorporated Business Tax—Deductibilty of Payments to a Deceased Partner's Estate

By the terms of a partnership agreement a surviving partner was given an option to retain the capital of a deceased partner in the business. Under the agreement the estate was to receive interest of 6% on the capital so retained plus 20% of the net profits. These payments the surviving partner deducted as a business expense, thus reducing the net income subject to the unincorporated business tax. The Tax Commission denied the deduction and the taxpayer appealed to the courts. In a per curiam opinion the Court held[20] that the arrangement with the estate created a limited partnership and the payments made represented a share of the profits and were not deductible as a business expense. One of the judges dissented as to the interest payment.

Capital Loss or Ordinary Loss

One of our members poses the question as to the proper treatment under the State income tax law of a payment made by the stockholder as a transferee of a liquidated corporation. This is the situation that was present in the case of *Com'r.* v. *Stanley Switlik*.[21] In that case the stockholders had liquidated a corporation and distributed its assets. The stockholders reported long term capital gains. Several years later the Commissioner determined some tax deficiencies against the corporation and these were paid by the stockholders who were liable as transferees. The stockholders deducted the entire amount as losses incurred in a transaction entered into for profit. The Commissioner characterized the payments as capital losses deriving their nature from the earlier liquidation which was a capital transaction under Section 115(c). The Tax Court determined that the capital transaction was concluded in the earlier years, and that there was no sale or exchange in the year the stockholders made payments to satisfy their liabilities as transferees. The losses were therefore held to be ordinary losses. The Circuit Court agreed with the holding of the Tax Court. It cited the decision in *North American Oil Consolidated* v. *Burnett*[22] which held that "if a taxpayer receives earnings under a claim and without restriction as to its disposition he has received income which he is required to return, even though . . . he may still be adjudged liable to restore its equiva-

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[18] *M. & M. Transportation Co.* v. *City of New York,* 84 N.Y.S. (2d) 128; affd., 278 App. Div. 1027 (1949).
[19] *M. & M. Transportation Co.* v. *City of New York* (S.D.N.Y., 1950).
[20] *Meyer* v. *Bates* (New York Sup. Ct., App. Div. 3rd Dept., January 10, 1951).
[21] United States Court of Appeals, Third Circuit (September 12, 1950), affg. 13 T.C. 121.
[22] 286 U. S. 417 (1932).

Accounting at the S.E.C.

Conducted by Louis H. Rappaport, C.P.A.

Earlier issues of this magazine contained 24 informal rulings of the SEC dealing with the question of independence of accountants. In this issue we publish the remainder of these rulings. The reader's attention is directed particularly to Number 27 in which the SEC said it would raise no question with respect to certification by an accountant who had a financial interest in a former subsidiary of a registrant but had disposed of that interest. Number 31 repeats the frequently expressed position of the SEC to the effect than an accountant cannot express an unbiased opinion on financial statements prepared from books which have been kept by him or members of his staff.

25. An accountant certified financial statements of securities dealers filed on Form X-17A-5 with the Commission. The accountant was considering an offer to serve as salesman for one of the securities dealers and inquired as to whether this would affect his independence with respect to dealers other than his prospective employer as to whom he acknowledged his lack of independence.

Held, accepting employment as a security salesman would place the accountant in the position of engaging in a line of endeavor incompatible with that of an independent public accountant and would affect his status with respect to certifying financial statements filed with this Commission. In this connection, Rule 4 of the Rules of Professional Conduct of the American Institute of Accountants was cited to the accountant.

26. An accountant who was elected director of a company in which his client held a 30% common stock interest submitted his resignation immediately after he was notified of his election. Inquiry was made as to whether the accountant could withdraw his resignation and, if not, whether his election disqualified him for any period of time.

Held, if the client and the company to which the accountant was elected a director were affiliated within the meaning of that term as defined in the General Rules and Regulations under the Securities Act of 1933, then serving as a director of either company would disqualify the accountant from certifying financial statements to be filed with the Commission. With respect to the interval of time during which the accountant served as a director, no question was raised, since it was indicated that the accountant resigned as soon as he was notified of his election and did not participate in a directors' meeting or act in that capacity.

27. After the close of the fiscal year October 31, 1946, "A" corporation distributed 250,000 of the 300,000 shares of its wholly owned subsidiary to its shareholders and retained 50,000 shares to use in lieu of cash to discharge some of its obligations. On November 29, 1946, 5,642 shares were given the accounting firm which audited "A" corporation's statements as part payment for fees due it. On December 8, 1947, these shares were sold

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's., and is also a member of the American Institute of Accountants and of the American Accounting Association.

through a brokerage house for cash. Inquiry was made as to whether the accountant could certify financial statements of "A" corporation for the fiscal year ending October 31, 1947.

Held, that since the accountants no longer had any financial or personal interest in either "A" corporation or its former subsidiaries, no question would be raised with respect to the certification. However, in the event of some adverse development in connection with the financial statement filed, the fact that at one time the accountants possessed a financial interest in the corporation would be given further consideration.

28. An accounting firm is paid a retainer for consultation services and to make studies and investigations for a hotel company.

Held, the accounting firm may be considered independent for the purpose of certifying the financial statements.

29. From 1940 to September 1946 a partner in an accounting firm was a director of a business corporation and during part of that time served as a member of its executive committee. Inquiry was made as to whether the accounting firm was qualified to certify the financial statements of the firm for the year 1947.

Held, that since the audit did not cover any of the time during which the accountant served as a director, no question would be raised with respect to the certification. However, since the independence of the accountant was a matter of fact, this opinion might be altered if it should develop that the 1947 audit was improperly influenced by the accountant's background of directorship or if any significant accounting policies formulated prior to 1946 persisted beyond that year.

30. A company which was liquidating and held only two blocks of securities had leased for a period not to exceed 18 months one room in a suite of offices held by an accounting firm. The company paid the same rental per square foot as the accounting firm for the remainder of the office space. Inquiry was made concerning the propriety of this arrangement, since the accounting firm certified to the financial statements of the company.

Held, arrangements of this type cast doubt upon the independence of the accountant, but in view of the special circumstances of this case the accounting firm would be permitted to certify the company's financial statements.

31. An inspection of a broker-dealer revealed that a member of the accounting firm which certified the financial statements of the broker-dealer also did the bookkeeping work and prepared the financial statements.

Held, the accounting firm cannot express an unbiased and objective opinion of work performed by its own staff.

32. An accountant certified financial statements used in a registration statement for the period ending December 31, 1947, under certificate dated March 17, 1948. Because of the resignation of the general manager of the company on May 7, 1948, and the general knowledge possessed by the accountant of the company's activities, he was engaged by the directors to reorganize the office and reallocate the duties of the executive personnel. Inquiry was made as to whether the accountant was qualified to certify the financial statements used in the registration statement for the purpose of a post-effective amendment dated June 30, 1948.

Held, that the accountant could be considered independent with respect to the financial statements for the period ending December 31, 1947.

33. A partner in an accounting firm responsible for the audit of the financial statements of an oil company and the son of the president of the company jointly acquired a 25 per cent stock interest in an oil equipment company. In connection therewith they obtained a bank loan of $200,000, signing a joint note and pledging the stock of the oil

equipment business as collateral. The president of the oil company indorsed the $200,000 note and pledged as additional collateral 2,500 shares of the oil company's stock. Inquiry was made as to whether the partner in the accounting firm, who has now resigned from the firm, is qualified to practice before the Commission.

Held, that these actions on the part of the accountant prevent his recognition by the Commission as an independent accountant with respect to any financial statements which the oil company has filed or may file covering the period of time when he was a member of the accounting firm which certified those statements.

34. A hotel requested an accounting firm to assign to the hotel one of their senior accountants, experienced in hotel auditing, to make a continuous audit of transactions from day to day. The individual assigned to this work was not to administer the accounting office nor to sign checks of the company, and he would not be required to make any entries in the books of account. The hotel had on its staff another person with the title of chief accountant whose duty it would be to administer the accounting office and to maintain the books of account. Inquiry was made as to whether the accounting firm would be qualified to certify the financial statements filed by the hotel company with the Commission.

Held, that under all the circumstances the accounting firm could be considered independent.

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lent. . . ." In the latter event the taxpayer would be entitled to a deduction in the year the taxpayer makes the refund. The Circuit Court rules out the view that the proper treatment is to reopen the return for the earlier year and reduce the amount of the capital gain there reported.

Our income tax law does not have any specific provisions relating to claims against transferees. The franchise tax law does have a provision (Section 216.4) making a transferee liable for taxes of a corporation. This provision was added to the law in 1946.

If the state were to follow the decision in the Switlik case the payments made by the transferee stockholder should be fully deductible as a business loss. If the payment is held to be a loss *resulting* from the sale or exchange of capital assets (Section 350.14) even though the exchange occurred in an earlier year, then the loss is a capital loss. There are no state cases or rulings on the point. Our own opinion is that the Tax Commission would adopt the latter rule.

Notes on the New York State Unemployment Insurance Law

Conducted by Samuel S. Ress

The following release, issued by the Information Office of the Division of Placement and Unemployment Insurance of the Labor Department of the State of New York, is published for the information of our readers.

New Job Insurance Law Explained

Industrial Commissioner Edward Corsi today (April 23, 1951) made public an explanation of the major changes in the New York State Unemployment Insurance system under the Hughes-Brees amendment which has been signed by Governor Thomas E. Dewey.

Scheduled to take effect in stages from June 4 through January 1, 1952, the changes affecting benefit claimants include an increase in benefit rates, determination of benefit rates on the basis of more recent earnings, revision of eligibility standards, and revisions in the method of payment for partial unemployment.

Of chief importance to employers is that under the new law they will know in advance what their tax rate for the coming year will be. In 1952, employers will be taxed on a graded scale, based on individual experience, which will vary from 1.7 per cent to 2.7 per cent of payroll.

After 1952, the arbitrary 1.7 per cent minimum rate will be eliminated. Firms with the most stable employment records eventually may pay no tax depending on the over-all condition of the Unemployment Insurance Fund. According to the law the rates will vary from zero to 2.7 per cent when the fund reaches 12.5 per cent of the previous year's payrolls ($1,250,000,000 at present payroll levels). At the end of March the fund stood at $916,000,000. For rating purposes, employers will be grouped in 20 tax classes, designed to gear the individual tax rate to individual experience more closely than in the past when there were only six tax credit classifications.

Under the new law the detailed quarterly payroll reports listing individual employees and their wages will be discontinued for all firms that have been subject to the law for at least three and one-half calendar years, but quarterly summary reports of contributions must be continued. "Younger" firms must continue the detailed quarterly payroll report and will also be required, as will all firms, to supply individual wage records "on request".

Whenever a benefit claim is filed, the Division of Placement and Unemployment Insurance will write to the appropriate employer or employers for wage information necessary to settle the claim. If an employer fails to respond within seven days the claim will be settled on the basis of available information, including the claimant's own statement, and benefit charges will be made against the appropriate employer account. Non-compliance with reporting regulations subjects an employer to a fine of $10 per case.

An individual account in the unemployment insurance fund will be established for each employer, to which his tax payments will be credited and all benefit charges debited. The status of his account and the over-all condition of the fund each July 1 will chiefly determine his tax rate for the next year, and an employer whose account shows a deficit will be

Samuel S. Ress has been an Associate Member of our Society since 1936. He is a member of the New York Bar and holds the Juris Doctor degree from the New York University School of Law, and the B.B.A. degree from The City College (New York) School of Business and Civic Administration. He is a tax consultant and has been a specialist in the payroll tax field since the inception of Social Security and Unemployment Insurance Laws in 1936. He has drafted legislation related to unemployment insurance, health insurance, wages and hours and workmen's compensation.

Dr. Ress, who has written a number of articles which have appeared in *The New York Certified Public Accountant,* is a member of the Society's Committees on Clothing Manufacturing Accounting and on Labor and Management.

taxed at the rate of 2.7 per cent of payroll for a minimum period of three years.

Employers who have been subject to the law since January 1, 1947, will get an initial account balance which will approximate their tax payments and benefit charge experience in the past. Employers in the system a shorter time will have initial balances established as of July 1, 1951, if they become qualified for experience rating July 1, 1952, 1953 or 1954. Employers entering the system after January 1, 1951, will start from scratch.

"The individual account balance will not represent any earmarked asset of the employer in which he or his employees have any vested right," Commissioner Corsi said. "The balance is a bookkeeping device for measuring experience—an account kept solely so a ratio can be struck each July 1 between tax payments and benefit withdrawals, for the purpose of fixing each employer's tax rate for the following year. All actual monies in the unemployment insurance fund are pooled for the payment of benefits to anyone entitled to payment, regardless of who his employer was and regardless of how his employer's account stands."

Under the amended law, after December 31, 1951, the benefit ratio for unemployed workers filing new claims will change from the present approximately 50 per cent of the claimant's weekly wage to as much as 66.6 per cent for claimants in the lower wage brackets. In addition, this law provides top payment of $30 a week after December 31, 1951, in the case of new claims as compared with the present $26 maximum rate. Until the end of this year, however, the old scale of benefits will be used and will continue until the individual benefit year ends.

Another major change in the law, the creation of a separate benefit year for each claimant, will go into effect July 2 of this year. Under this revision, a claimant's benefit year will begin the first Monday after he files a valid claim, and eligibility will depend on his employment record in the 52 weeks prior to his filing a claim. To begin a benefit year on or after July 2, a claimant must be unemployed, available for work and able to work, must not be subject to any disqualification or suspension, must have a record of some covered employment in each of at least 20 of the preceding 52 weeks and earnings averaging at least $15 a week in 20 of those weeks.

Because the individual benefit year plan will not take effect until July 2, the new law extends the current benefit year from June 4 to June 30, and increases the maximum number of benefits for the current year from 26 to 28. Commissioner Corsi explained that under this extension persons who are unemployed during June and have already exhausted 26 weeks of benefits may apply beginning June 4 for up to two more weekly payments.

Under the new law claimants who do not earn more than $30 a week and who work less than four days a week will receive promptly any partial benefits due them for that week. Under the old law claimants accumulated credit but did not receive payments until they had accumulated the equivalent (4 credit days) of a full week's unemployment.

Timetable for Principal Changes Affecting Benefit Claimants Under Amended Unemployment Insurance Law

June 4 to June 30, 1951 (Transitional Period)

1. Current benefit year extended from June 4 to June 30.
2. Benefits during this period continue to be based on 1949 earnings under old law schedule.
3. Maximum benefits increased from 26 to 28 weekly checks for current benefit year only because of extension of benefit year. (Jobless persons who have received 26 checks may apply on or after June 4 for up to two more checks in June.)
4. Allowed earnings in week of "partial unemployment" upped from $24 to $30.
5. Persons receiving benefits in June will have benefit rights for benefit year beginning July 2 determined automatically based on 1950 earnings, (under old law) and can get waiting period credit in June for the new benefit year which begins July 2.
6. Any person now ineligible (on 1949 earnings) may file a claim between June 4 and June 30, and if he is able to serve his complete waiting period then, will have a benefit rate for the benefit year beginning July 2 established on the basis of 1950 earnings, under the old law schedule.

Changes Effective July 2 to December 30, 1951

1. Each new claimant will have an individual benefit year—52 weeks, starting the Monday after he files a "valid original claim". The individual benefit year will begin July 2 for those persons whose benefit rights, based on 1950 wages, are determined in the month of June (see 5 and 6 above).
2. Benefit rate for all new claims filed July 2 or later will depend on high quarter earnings in 1950 (if 1950 earnings were $300 or more), or on high quarter earnings in 1951 under old law schedule.
3. No new claimant applying July 2 or after can start a benefit year until a "valid original claim" is filed.
4. Five conditions determine whether a claim is a "valid original claim":
   a. The claimant must have had some

covered employment in each of at least 20 weeks in the 52 week period preceding the filing of the claim; and have earned an average of at least $15 per week in 20 of these weeks.

b. His old benefit year, if any, must be ended.

c. He must not be subject to any disqualification or suspension.

d. He must be unemployed, able to work, and available for work.

e. He must have at least four days of unemployment (one "credit day") in the week he files his claim.

Changes Effective for New Claims Filed on and After December 31, 1951

1. Maximum benefit rate will be increased from $26 to $30.
2. Benefit rate will be based on average weekly wage.

Timetable on Changes Affecting Employers Under Amended Unemployment Insurance Law

Changes Effective June 4, 1951

1. Any employer who contests the decision of an unemployment insurance office with respect to a benefit claim and asks for a hearing is required to deposit $10. If the referee overrules or modifies the decision the deposit will be returned; if not it will be deposited in the unemployment insurance fund.
2. Any employer who appeals from a referee's decision to the Appeal Board must deposit $25. If the referee's decision is modified or overruled the deposit will be returned; if not it will be deposited in the unemployment insurance fund.

Changes Effective July 1, 1951

1. When a benefit claim is filed, necessary base period employers will be asked to furnish information in order to establish the claimant's eligibility and benefit rate. This information must be supplied within seven days of the date the request is mailed. (Exceptions will be made in a limited number of industries for which other arrangements will be prescribed.)
2. If an employer fails to supply wage information on request within seven days he will be subject to a $10 fine in each case, and the claim will be settled on the basis of whatever other information is available, including the claimant's own statement of his earnings.
3. Under the "request reporting" plan, most employers will be exempted from filing detailed quarterly payroll reports listing all employees and their earnings.
4. All employers must continue to file quarterly *contributions* reports as distinguished from quarterly payroll reports.
5. An individual rating account will be established for each employer. His tax payments will be credited to this account and benefits paid to former employees will be debited.
6. Weekly reports will be sent all employers of any benefit charges against their accounts.
7. Individual account balances will be established for all employers who have been subject to the law since January 1, 1947, have filed all required reports since then and have paid all required taxes. The initial account balance will approximate the difference between a firm's tax payments and benefit charges in the past. Notice of this balance will go to each employer.

   Note: Employers who became subject to the law after January 1, 1947, will be able to qualify for initial account balances as of July 1, 1952, 1953 or 1954, after they have been in the system for at least 14 calendar quarters.

   Note: Notice of individual account balance of any employer who owes back taxes will be withheld. He will be notified of his delinquency. But no initial account will be established if the employer does not pay his contributions due in full on or before the last day of the calendar quarter which begins after he was notified of his delinquency.
8. A "general account" will be established, made up of the difference between the total amount in the fund and the total of employers' initial account balances. This general account will be credited with interest earned on the fund, interest and penalties collected from employers, lapsed employer account balances, proceeds from emergency contributions, recoveries on benefit overpayments, and tax payments due before July 1, 1951 but received after that date. The general account will be charged with the amounts of negative balances in employers' accounts and with benefit payments which are not chargeable to any individual employer's account. If the general account balance drops below a specified level, an emergency contribution will be imposed on all employers.
9. Tax rates for 1952 will be determined July 1, 1951 and will range between 1.7 per cent and 2.7 per cent of payroll. Principal factor in determining the rate

(Continued on page 372)

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Binding Work Papers

Keeping workpapers intact during the course of an engagement is important because the ability to locate individual papers for use or review will save considerable time in the aggregate, and reduce strain on accountants' nerves.

Metal fasteners, side-bind or top-bind, are popular devices for keeping papers in place. However, the removal and reinsertion of papers is a nuisance in such cases because of the time involved in opening the fastener, removing certain papers to get to the desired sheet, replacing the removed papers, and closing the clasp. When the subject sheet is to be returned to its place the same routine is followed. Some accountants avoid this inconvenience by using no clasp at all.

There are two other binding devices which make the removal and reinsertion of papers easy, save time in the removal and return of the complete folder to the files, and reduce misfiling of individual papers. These gadgets are the ring binder and the spring binder. Such devices are being used by some accountants with great satisfaction.

The use of ring and spring binders presents certain problems, to wit, work paper to fit the binders, file shelves, binder sizes, etc., all of which can readily be worked out in most cases.

Preservation of Records

We constantly hear about the efforts being made by banks and other businesses to preserve a duplicate set of records as a safeguard against the destruction of original records. Microfilm is the great medium for making it possible not only to prepare a duplicate set of records easily, but also to eliminate space as a problem. Moreover, large warehouse companies are now making available storage space in remote sections of the country.

Accountants also have important records to preserve, and incidentally solve the ever-pressing problem of file room space. Useful information on microfilming is readily obtainable from many sources (see the ads in our magazine) and from an article in *The New York Certified Public Accountant,* issue of December, 1948, by George N. Farrand, and an article by Irving Zitmore in the *Journal of Accountancy,* issue of February, 1951.

Time and Cost Records

The accumulation of the daily time record of staff accountants and other personnel, both for determining costs of engagements and for billing, is essential in the administration of the public accountant's practice. There are a wide variety of forms in use for the assembly of such data though the objectives are essentially the same.

Two basic forms are involved, namely, (1) the employee's time record and (2) the client's time record. Other forms in use are adjuncts of one or the other.

As to the employee's time record, there is one major variation in the forms in use, to wit, some provide for "costing" of the hours directly on the form so as to permit the posting of hours and dollars to the client's time summary record, whereas others do not contain the cost provision. Where the "costing" is not done on the employee's time sheet it is done, if at all, on the

EXHIBIT 1

TIME REPORT

CLIENT'S NAME	NATURE OF ASSIGNMENT		DISTRIBUTION OF TIME BY DAYS																REG.	DATE	AMOUNT	POSTING CODE
			1 16	2 17	3 18	4 19	5 20	6 21	7 22	8 23	9 24	10 25	11 26	12 27	13 28	14 29	15 30	31				
TOTAL CLIENT'S HOURS																						
ADMINISTRATIVE																						
UNASSIGNED																						
TAX AND ACCOUNTING RESEARCH																						
NAME	TOTAL HOURS PRESENT																					
	HOURS ABSENT: ILLNESS																					
	HOURS ABSENT: VACATIONS AND HOLIDAYS																					
	HOURS ABSENT: OTHER TIME OFF																					
HALF MONTH ENDED	TOTAL HOURS RECORDED																					

EXHIBIT 2

UNBILLED RECEIVABLES – CLIENTS

REGULAR WORK

LEDGER SHEET NUMBER______

Client______________________

Address______________________

Attention:______________________

Billings must be on basis indicated and must be approved by partner in charge.

Basis of Billing

Monthly______; Quarterly______
Annually______; Assignment______

Fixed monthly charge______________

Partner to review bill______________

Date	Accountant or Invoice No.	DESCRIPTION OF WORK PERFORMED, NATURE OF EXPENSE OR SUMMARY OF INVOICE	Hours Charged	AMOUNT OF CHARGED TIME BY CLASSIFICATION: Partners	Tax Staff	Audit Staff	Office		Amount of Expense	BILLING: Adjustment	Amount of Bill	Balance Unbilled
		Balances forwarded										

TIME SUMMARY

EXHIBIT 3

CLIENT ______________

Page___ of___

File #

Week Ended	Staff No.	Period Ended	Hours Engaged: S	SS	J	C	X	E	Week Ended	Staff No.	Period Ended	Hours Engaged: S	SS	J	C	X	E	Week Ended	Staff No.	Period Ended	Hours Engaged: S	SS	J	C	X	E
Totals Forwarded-									Totals Forwarded-									Totals Forwarded-								

Code: S- Senior
SS- Semi-Senior
J- Junior
C- Comptometrist
X- Supervisor
E- Executive

Note: All time recorded in blank column to be explained on same line.

TOTALS	TOTALS	TOTALS
Totals Forw'd-	Totals Forw'd-	Totals Forw'd-

client's record. The cost calculation, either at a "cost rate" or a "billable rate" is usually done by an office employee.

Exhibit #1 is a representative time record for a staff accountant.

Exhibit #2 is a representative summary form, for an individual client, of the accumulated time cost (the costs are posted from the form in Exhibit #1) and expenses. In Exhibit #3, also a client's record, the time is posted only in hours and the "costing", if any, is made on another form. In some instances the client's cost record is integrated with the fees receivable ledger.

A fourth form (not illustrated) is used to summarize the time cost for billing purposes. It is useful for annual audits and special engagements.

Office Managers' Luncheon Meetings

The first luncheon meeting of office and staff managers of accounting firms in the midtown area was held on Tuesday, April 24th, at 12 noon, in a private dining room at the Hotel Lexington, 48th Street and Lexington Avenue. Ten men were present and it was the consensus that such meetings will fill a real need, in a pleasant manner.

Luncheon groups will eventually be organized in the downtown and other areas. All groups will be made as homogeneous as possible and may be divided as between national and local firms, or otherwise, to maintain the maximum mutual interest.

If you are interested in attending such meetings, write to

The Editor, Office and Staff Management,

The New York Certified Public Accountant

677 Fifth Avenue, New York 22, N. Y.

for information as to the group meeting in your neighborhood.

Follow-Up

Your cooperation is earnestly solicited in making available to this department administrative data and forms that may be helpful to fellow practitioners and the profession generally. Unless specified, the names of contributors will be published with their material. Inquiries dealing with administration of accountants' practice may also be sent to the Editor.

Notes on the New York State Unemployment Insurance Law

(Continued from page 369)

will be the employer's initial account balance as of July 1, 1951 as it reflects his benefit experience.

10. For tax rate purposes, employers will be divided into 20 classes instead of the six classes fixed by the old law. As a result, an employer's tax rate will be geared much more closely to his individual benefit experience.
11. Any benefits paid after June 30, 1951 will be charged to the appropriate account. Benefits paid on new claims filed between July 2 and December 31, 1951 will be charged to the employer who paid the most wages to the claimant in his base year. Benefits paid on new claims filed on and after December 31, 1951 will be charged to the claimant's base period employers in inverse chronological order, at the rate of one week's benefit charge for each week of employment provided in the base period. If a claimant receives benefits for more weeks than he had base period employment, the excess charge will be against the general account. No employer will be charged for more weeks than he provided weeks of employment.

Changes Effective January 1, 1952

1. The arbitrary minimum tax rate of 1.7 per cent of payroll is eliminated. When the fund reaches 12.5 per cent of the previous year's payrolls, rates will vary from zero to 2.7 per cent.

The Excess Profits Tax Exchange

Conducted by David Zack, C.P.A.

This column reiterates its request for any and all questions, problems and comments regarding Excess Profits Taxes. Items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

> Editor, The Excess Profits Tax Exchange
> The New York Certified Public Accountant
> 677 Fifth Avenue
> New York 22, N. Y.

Excess Profits Credit Alternatives

Many practitioners have inquired about the choice of excess profit credits. There is no election, in the technical sense, as to the choice of the average earnings method or the invested capital method. Section 434 of the Internal Revenue Code *requires* that the taxpayer use whichever credit results in the lesser tax for the taxable year for which the tax is being computed. This of course means that the taxpayer has an absolute right to change his method every year and even within a particular year the method may always be changed to yield the least tax, subject of course to the restrictions of the statute of limitations. Thus, changes in the base period net income made by an examining revenue agent may make the average earnings method more desirable than the previously indicated invested capital method. The law requires the Bureau of Internal Revenue to recompute the excess profits tax on the average earnings method since that would yield the lower excess profits tax.

However, within the Invested Capital Method, there is an irrevocable election which may be exercised by the taxpayer. Section 537(b)(1) of the Internal Revenue Code provides for the election, by the taxpayer, in its return, of the historical invested capital method provided in Section 458. Regulations 130, Sec. 40.437-2(c) makes this election irrevocable for the taxable year. There is a new election every year and despite the election for a particular year, the taxpayer still has a right to shift to the average earnings method. The election applies only within the invested capital method. The election applies when the historical method is originally elected on the tax return and even then it forecloses the use only of the asset method for that particular year. In any event, great care should be exercised before the historical method is used on the excess profits tax schedule.

David Zack, C.P.A., is a member of our Society and of its Committee on Municipal and Local Taxation and the Committee on Education.

Mr. Zack is a member of the New York Bar, the Federal Bar, and the Tax Bar. He is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration, where he is currently conducting an intensive course on the New Excess Profits Tax Act.

Mr. Zack has written on tax matters for various publications. He is engaged in tax practice with a prominent New York firm of certified public accountants.

Net Operating Losses

The subject of net operating losses, carrybacks, carryforwards and deductions has never been simple, but it has

been even further complicated by the Excess Profits Tax Law. B. F. Schonberger, C.P.A., has submitted the following schedules which should help guide the weary practitioner through this very complex maze.

(A) *Adjustment for Year of Loss*

Start with the excess of deductions over gross income without regard to any net operating loss deduction. Such amount must then be reduced by the following:

(1) excess depletion (Sec. 122(d)(1))

(2) wholly tax-exempt interest (Sec. 122(d)(2))

(3) If the taxable year ends after 6-30-50 or begins before 7-1-53, the adjustment for interest on borrowed capital under Sec. 433(a)(1) N or O, depending upon whether the excess profits credit for that year is computed under the invested capital or income method.

(B) *Conversion of Net Operating Loss into Carry-Back or Carry-Over*

The amount of the carry-back or carry-over to a taxable year is the excess of the net operating loss over the net income for each year through which the carryback or carryforward passes, adjusted as follows:

(1) Compute the Net Operating Loss deduction without regard to the Net Operating Loss for the taxable year and for succeeding years, and without regard to the reduction specified in (C) below.

(2) Adjust for excess depletion.

(3) Adjust for wholly tax exempt interest.

(4) In computing the net income for a year ended after 6-30-50 or begun before 7-1-53, for excess profits tax purposes only, make the adjustment for interest on borrowed capital.

(C) *Adjustment for Year of Net Operating Loss Deduction*

Start with aggregate of carrybacks and carryovers to the year of the net operating loss deduction. Reduce such amount by:

	For Purposes of: Income Tax	For Purposes of: Excess Profits Tax
(1) Excess depletion	Yes	Yes
(2) Wholly tax exempt interest	Yes	Yes
(3) Partially tax exempt interest	Yes	Yes
(4) Dividend Received Credit	Yes	No
(5) 100% of Dividends Received (unless from stock not a capital asset)	No	Yes
(6) Capital gains and losses (to the extent included in net income)	No	Yes

Note: In computing the *unused* excess profits credit, the excess profits net income must be computed without the allowance of a net operating loss deduction.

Growth Corporations

Section 435(e) of the Internal Revenue Code provides for an alternative average base period net income based on growth. Qualification for this method involves detailed computations and onerous research into the records of the taxpayer. It may frequently happen, after many tedious hours of work, that a corporation's qualification for the growth formula is purely academic because the relief available is in-

adequate. Since it is comparatively easy to compute the various relief alternatives, many practitioners are following the practice of determining the possible relief available under the growth formula before undertaking the research necessary to establish qualification. In many cases, the prescribed relief alternatives provide no advantage so further time need not be spent in pursuit of the growth will-of-the-wisp.

In determining the relative advantages of the general average under Section 435(d) and the growth formula under Section 435(e) it must be remembered that the general average may be augmented by the base period capital addition under Sec. 435(f) whereas the growth formula has no such advantage. It is therefore fallacious to make a direct comparison of the general average with the growth formula, the base period capital addition must be added to the general average before comparison with the applicable growth provision.

Many questions have been raised as to whether a corporation which succeeds a sole proprietorship, partnership or predecessor corporation some time after the beginning of the base period may qualify as a growth corporation. The law (Sec. 435(e)(1)) requires that a taxpayer must have commenced business prior to the beginning of its base period. However, Section 461(d) specifically provides that for the purposes of sections 435(e), 442, 443, 444, 445 and 446, an acquiring corporation "shall be considered to have been in existence and to have had taxable years for any period during which it or any of its component corporations was in existence, and such corporation shall be considered to have commenced business on the earliest date on which it or any of its component corporations commenced business". Partnerships and transferor corporations may qualify as component corporations under Section 461(b) of the Internal Revenue Code.

Base Period

Samuel B. Pollack, C.P.A. and attorney, sends in the following question:—

> "The statute and the regulations talk constantly of a taxpayer which 'commenced business on or before the first day of its base period.' I understand the base period to be the period beginning January 1, 1946, and ending December 31, 1949. A taxpayer who was not in business during those years cannot use that base period. I do not understand why this language is used if in order to use the base period the taxpayer is required to have been in business during that period. Also why the emphasis on *its?* The base period years are the same for every taxpayer, aren't they?"

The base period years are not the same for every taxpayer. It is true that the base period for most taxpayers is the period from January 1, 1946, through December 31, 1949. However, if a taxpayer's first excess profits tax year was preceded by a year beginning in 1949 and ending in the first quarter of 1950 (January 31, February 28, or March 31, 1950), its base period is the 48 consecutive months ending with the close of that year (Section 435(b)).

A taxpayer need not have been in business during the entire base period in order to use the general average method. This average earnings method is available to all taxpayers, notwithstanding when business was commenced. During the period when the corporation was not in business its earnings will be treated as zero (Section 435(d)). However, a corporation which began business after the beginning of the base period is foreclosed from the use of the growth alternatives (Section 435(e)).

Last Call For

1951 PRIZE ESSAY CONTEST!

The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest among seniors and graduate students majoring in accountancy, duly enrolled in the colleges of New York State. The article may cover any topic in the field of accounting and/or auditing.

Prizes in the amount of $100 for the best article and $50 for the second best article are offered. In addition, the two winners and any others submitting papers worthy of honorable mention will receive a one-year subscription to *The New York Certified Public Accountant.*

The General Rules of the Contest are as follows:

> All papers shall be original, and the manuscript shall be typed in duplicate on 8½ x 11 stationery on one side, double or triple space typing, and shall not be more than 6,000 words in length. Each contestant shall indicate the exact number of words in his paper at the end thereof.
>
> ★
>
> The name of the individual submitting the paper shall not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address. When submitted to the judges, each manuscript will be given a key number for identification.
>
> ★
>
> Manuscripts should be forwarded to The Managing Editor of *The New York Certified Public Accountant,* 677 Fifth Avenue, New York 22, N. Y., on or before May 15, 1951. Awards will be announced as soon thereafter as possible.
>
> ★
>
> All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant.* The decision of the judges shall be final as to what papers, if any, may be entitled to prizes.

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